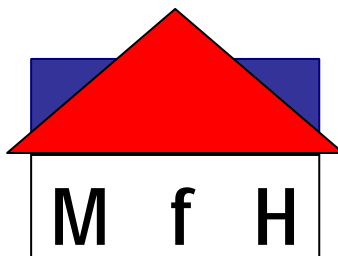


**FAULU KENYA LIMITED/
USAID MICROPED GRANT FUND
Award No. 623-A-00-01-00005-00**

INSTITUTIONAL STRENGTHENING AND CAPACITY BUILDING PROGRAMME

FINAL EVALUATION REPORT

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APPRECIATION

This report contains the results of an evaluation of the “Institutional Strengthening and Capacity Building Programme” funded by the USAID MICRO-PED Grant between 28th February 2001 and 28th February 2004. Mrs Ruth Odera of Microfinance House Limited in collaboration with Gervase Odiko of Microde Consult and Francis Ogutu of Lattice Consulting carried out the evaluation.

The evaluation exercise was undertaken between February 27th and March 26th 2004. During this period, the team held discussions with Faulu management team at the head office and with the board of directors at their offices. The team evaluated all the major aspects of the grant based on the Terms of Reference (Ref. Annex 1).

The evaluation of Faulu was carried out on the basis of information and data presented by the management of Faulu - information which they fully relied on with minimum verification. The evaluation work was feasible because in most cases, information and up dated data was available at the head office. The management team was very open and supportive in discussing all the issues during the whole evaluation exercise. The team acknowledges this as a great achievement for Faulu Kenya.

The team wishes to express its appreciation to Faulu Kenya management and board members for their collaboration and hopes that this exercise will move Faulu towards its main goal of becoming a leading provider in microfinance in Kenya.

The views expressed in this document are those of the consultants and do not in any way reflect the views of Faulu Kenya or USAID. Our report is based on information available to us through various interviews and high-level discussions with various staff of Faulu Kenya and USAID.

DEFINITIONS

Acronym	Definition
CAGR	Compounded Average Growth Rate
CEO	Chief Executive Officer
DFO	Development Finance Officer
DOS	Disk Operating System
EVA	Economic Value Added
FAO	Food and Agricultural Organisation of the United Nations
FKL or Faulu or Faulu Kenya or The Company	Faulu Kenya Limited
GTZ	German Agency for Technical Cooperation
LSF	Loan Security Fund
MBWIN	MicroBanking System for Windows
MMR	Monthly Monitoring Report
CSR	Client Status Report
PTR	Period Transaction Report
USAID	United States Agency for International Development
PEP	Participatory Evaluation Process
The Project	USAID Micro-PED Grant Funded capacity building project at Faulu Kenya Limited or its sub-projects

EXECUTIVE SUMMARY

This report covers an evaluation of the “Institutional Strengthening and Capacity Building Programme” implemented by Faulu Kenya Limited. The aim of the programme was to improve the capacity of Faulu to become a leading provider of financial services to small and micro-entrepreneurs in Kenya. The U.S. Agency for International Development (USAID) funded the three-year programme under the MicroPED Grant fund. USD430,450 was availed for (a) Strengthening the role of Faulu Board of Directors through workshops and exposure visits; (b) Developing human resource through training and exposure visits (c) Developing new products/services and strengthening lending procedures and operations; and (c) Upgrading the loan tracking system, improving management information system and establishing internal control systems.

The purpose of this final evaluation was to assess the effectiveness of the intervention against the aims and objectives set out in the proposal. Specifically, the consultants were expected to:

- Assess the progress of the project in achieving its objectives;
- Assess the efficiency, effectiveness of the project implementation mechanisms;
- Determine the impact of the project on Faulu Kenya;
- Provide specific recommendations for Faulu Kenya and USAID that will guide the design and implementation of similar projects in future.

Major Findings

A. Progress of Project in Meeting its Objectives

The evaluation revealed that the implementation of the programme activities under the Institutional Strengthening and Capacity Building programme implemented by Faulu was right on track despite major challenges experienced. Some of the major challenges Faulu experienced during the implementation of the programme included timing of all the activities to fit into the programme time-frame and the large magnitude of activities taking place concurrently. By the time of the evaluation, the programme had achieved the following progress.

Strengthened the Board of Directors to provide Governance

Faulu Board of Directors were trained in corporate governance and are now well - informed on matters relating to microfinance. Faulu board members have skills as leaders and have a clear vision of where Faulu should be in the long-run. They have fully bought into the mission of Faulu and are alert to its performance. The Board of Directors have developed a Board of Director’s Handbook which among other things clearly defines the responsibility between the board and management, functions, structure, systems and styles. The handbook also has chapters on board meetings, frequency agenda and board information on decision making.

Developed Human Resource

Faulu has well-trained professional staff capable of responding to organizational change currently taking place and to client needs. Staff underwent several training courses which included induction training for new staff, computer package training and functional training for old staff. The Chief Executive Officer underwent training at the Stanford Business School and one board member and eight senior staff of Faulu participated in an exposure programme in Bangladesh. Two members of staff attended the Microfinance Summer Academy Course conducted in Boulder/Frankfurt, Germany a two-week microfinance course offered during summer of every year.

Developing New Products and Services

Faulu developed, branded and rolled out three business loans and two consumer loans. The branding of the products provided identity necessary for differentiation. The products included *Pamoja*, a basic business loan for working capital for first-time micro and small-scale business clients currently without experience with formal financial services; *Fanaka*, a working capital loan for existing clients who require larger amounts than *Pamoja* loans; and *Fanaka Plus*, a loan product for relatively bigger growth businesses which enables the “Jua Kali” enterprises excluded from financial services by both microfinance and mainstream financial institutions to access credit in smaller self-selected groups. *Elimisha* loans are a school or college fees loan and *Mara Moja* a loan for emergencies.

Strengthening Lending Procedures and Operations

After the launching of the new products, Faulu experienced a lot of constraints in its internal system. It undertook a major restructuring in order to improve efficiency and balance its own needs and those of clients. Apart from re-allocating its business units to improve client service, it has reviewed its target market, collateral policy, client incentive system, loan officer incentive systems and interest rate structure. As a result, the delivery system and mechanism is more responsive to client needs. A lot of work is still being done to ensure that there is optimal gain from the current delivery system.

Loan Tracking System, MIS and Internal Control System

The Loan Tracking System was implemented and the software and hardware to run the MS Exchange e-mail system has been purchased and installed and the system is operational. Another project, the Business Process Improvement project and is currently going on. The internal audit system is in place.

B. Impact on Faulu

Overall, the key financial impact of the project has been very positive, but it has also presented some challenges that Faulu did address. By the time of the final evaluation, there was:

- A significant improvement in the economic value added (EVA) by the company from a value-destroying position in 2000 to 2002, to a value creating position in 2003 – meaning

that if this is sustained, then the company is in a good position to raise additional commercial equity if it so requires;

- Rapid growth beyond Faulu's sustainable growth rate has led to significant improvements in profitability;
- Achievement of financial and operational sustainability;
- Consistent improvement in operational efficiency;
- A very positive and growing impact on job creation and stabilisation;
- A very positive impact of LTS project on Faulu as it has enabled Faulu to cope with the rapid growth in the last three years;
- A very positive impact on the staff, leadership and board abilities to manage and provide governance;
- A very positive impact on Faulu's capability to undertake new product development and refinement;
- Deterioration in the quality of the loan portfolio;
- Regulatory exposure through funding advances out of the loan security fund (LSF).

C. Efficiency of the project implementation mechanisms

Efficiency is gauged by whether the results were obtained at reasonable costs (financial) and how well the means (financial, time, human resources) and activities were converted into results. Overall the implementation of the project was efficient in terms of costs and conversion of activities into results. The main components that posed efficiency challenges were in the MIS where cost overruns occurred; and in strengthening of service delivery system where operationalization of outputs brought in other problems.

Governance, Leadership and Human Resource Development

The external training, the study visits and other staff training planned for were carried out according to plan. The study visit to Bangladesh had representation from all cadres of human resources: DFOs, middle management, senior management and even one board member. This is very commendable as it doubled up as a team building activity. This was therefore found to be an efficient use of resources. It is however difficult to measure the efficiency of the staff training sub-component as no output reports and plans were availed to the evaluators.

Product Development and Strengthening of Service Delivery System

The implementation of Product Development component was efficient because: (i) most of the original work plans starting from the assessment and analysis of Faulu Kenya market and clients, and product and strategy development were complied with and at times, targets surpassed. For example, according to the proposal, 2 loan products were to be developed and rolled out but instead, 5 were developed and rolled out, (ii) Costs through which the component was done was reasonable. The estimated person days of complex product

development¹ using MicroSave-Africa qualitative research tools is 104 days at an estimated cost of USD37,000. This is in line with the amount used for the product development process which was USD39,443². The various activities carried out for the Research and Development component were relevant and the resources used were adequate for the activities.

The process of carrying out the product development activities was professional and adequate as it led to the launching of 5 new/refined products which has enabled FKL to grow tremendously within the Grant period. The consultancy, through which the activities were carried out, was awarded to Fineline Systems and Management Limited, a consultancy firm specialised in providing strategic advice, technical assistance, and training to institutions involved in microfinance and small enterprise development whose in-house staff and associates have the accreditation from MicroSave Africa and the expertise to undertake this activity.

The operationalization of outputs from product development posed great challenges for the operations department. Faulu had to implement a lot of other activities to ensure that the delivery system could cope with growth.

Management Information System

In the absence of any data on the detailed project plans (including Gantt charts, financial breakdown, human resource allocations etc), the review of the efficiency was restricted to a review of the variance between budgeted costs and actual costs. There was a 75% overrun in the budget for MIS related expenditure. Cost overruns in the LTS project are both an indication of poor anticipation of all the components of the project, leading to scope variations.

¹ Graham A.N. Wright "Market Research and Client-Responsive Product Development" pp 11

² For customer and market intelligence survey of the Kenyan Microfinance sector, training and discussion workshops between the consultants and Faulu Kenya, review of FKL service delivery systems and costing per service, design and development of product prototypes, revising policies and procedures manual, developing marketing market positioning strategies, reviewing of lending operations and costing and pricing of new products.

D. Effectiveness

Effectiveness can be gauged by the contribution made by the results to the achievement of the project purpose. Overall, the project has been very effective in achieving the project purpose. Board efficiency has improved, staff is well trained and can now respond to organizational and client needs, Faulu has grown in terms of outreach and is now a market leader in microfinance reaching over 20,000 clients with a fairly wide range of products that meets a variety of needs. Faulu is also on its way to establishing an efficient delivery system and an MIS system.

Governance

During the evaluation, the team saw signs of improved effectiveness in the manner the board conducted its affairs. The board recently set up committees: Executive Committee, Risk Management Committee and Internal Audit Committee. These committees are accorded specific tasks and they report to the board during their meetings. It was also found out that board members go to meetings more prepared. This is because they have realised that to participate effectively in board meetings, they have to take time and read board papers and minutes in advance. The meetings are characterised by informed discussions, are professional, brief and to the point. Even though the availability of plans were reported, the evaluation team was not able to find quarterly plans for the board and staff activities to enable it measure the elements of effectiveness as seen from the perspectives of the institution.

Human Resource Development

The purpose of this component was to, among other things; prepare the management and other staff members to operate in a private commercial institution. This meant not just acquiring technical skills to function, but also changing the thinking of staff from welfare/relief type of operation. Study visits to successful MFIs in other continents were found to be a major eye opener to staff. The staff learnt on the need to simplify and standardize operations. External training, especially in internationally recognised institutions like the Frankfurt Summerakademie was found to be effective in making staff see the bigger picture of the microfinance industry. It had the effect of making staff see where Faulu is vis-à-vis the other MFIs in the world. These activities were found to have contributed effectively to changing staff thinking and attitude.

Product Development

After the launching of the new products, Faulu grew tremendously. Faulu has built up a strong market position in its areas of operation and is a market leader reaching over 20,000 clients. The product development exercise involved not only contracted consultants but also a cross-functional internal team from different parts of the organization (personnel, marketing, finance, information technology, operations, and human resource departments) as well as branch representatives and field officers. The use of internal staff as part of the team during the market intelligence and customer survey, prototype development, and launching of the new products enabled Faulu to build a strong in-house capacity for product development or

refinement. Faulu is now able to respond adequately to client needs through its various departments and persons developed.

Service Delivery System

The operationalization of product development outputs posed major challenges to Faulu. It also did not anticipate the extent to which the very fast growth as a result of the new products would constrain the delivery system. Faulu needed to ensure that institutional systems are in place to cope with increased administrative burdens that accompany more products, more staff and more clients. The procedures should have been sufficiently tested to ensure that the staff do not make any mistakes or the operating system should have been ready to support growth. The other challenge was the timing of all the events to ensure all was systems-go before the launching of the new products. Without all these pre-conditions, there has been poor indicators in the areas of portfolio quality, client retention rates and repayment rates. Faulu undertook a major restructuring of its operations to make delivery of services efficient.

The restructuring of operations has led to greater benefits for Faulu as follows:

- Faulu Kenya now has clear and well-defined lending policies detailed in the Loan Policy and Procedures Manual which is regularly revised to take into consideration discussions and changes that take place at customer level and industry level;
- The incentive system is clear and well documented and Development Finance Officers (DFOs) are aware of and understand the rewards and penalties;
- As of this year, loan delivery is very fast and has reduced from the former 20+ days to only 10 working days and is set to reduce even to 5 working days with the implementation of the Business Process Improvement project currently being implemented by Faulu Kenya;
- Faulu's interest rates are quite competitive and are in line with what the other major MFIs in the Kenyan Financial sector are charging. For example, for loans of less than KShs100,000 the major Microfinance Institutions (MFIs) are charging 18%-24% while commercial banks are charging between 14%-23% and Faulu charges has reduced from 22% to 18% and even goes down to 15% with good repayment records.

Faulu partners from USAID have ascertained that the project implementation was very effective and efficient. During the implementation period, reporting was done according to the contractual agreement or fully discussed between the partner and the Chief Executive Officer of Faulu in crucial meetings or through written communications. The resources, according to the partners, were well-spent.

E. Sustainability

Faulu's current activities can survive even without the continued support from USAID. The organization has developed sufficient institutional capacity to continue with leadership, governance, operations, and product development. Faulu is set to diversify into other services such as salaried loans and business development services – services which are still under pilot testing. These will bring in user fees and invariably strengthen Faulu's position to stand survive on its own. Also, Faulu is profitable and could use some of its profits to strengthen its current activities and others generated by the Programme.

Having said that, we can add that a lot of changes have taken place in the Kenyan financial environment in the past two years, requiring Faulu to take several steps along its growth agenda. The MFI Act is in parliament for enactment and MFIs including Faulu may be empowered to provide savings and credit services to a larger population. Faulu may still need support from USAID in areas of MIS improvement, product development and further staff development in preparation for deposit taking.

F. Recommendations

Having discussed the efficiency, effectiveness, sustainability and impact of the project on Faulu, the following recommendations are focusing on various issues that Faulu need to resolve either in-house or with technical assistance from its partners to improve on its efficiency. Faulu has recognized some of the issues and undertaken measures e.g. in areas of deteriorating portfolio, MIS, etc. Other measures are also important for ensuring the Faulu retains its strong position of a leading provider of services.

I. Governance, Management and Staff Development

- The idea of a Board of Director's manual is an excellent one. To be of more use the manual should "stay alive" - i.e. it should be continuously up dated with the expected performance of each board member. It is recommended that the board consider reviewing the manual as a permanent agenda item for the annual board retreats.
- Reports assist Human Resources Department design training courses to offer to staff in future. Without these reports, quality of activities cannot be monitored and ensured. It is recommended that Faulu improve in its documentation system.
- Exposure visits are an important tool for learning. Local ones are even stronger due to similarities in environments. It is recommended that FKL include local exposure visits in their capacity building programmes.
- It is recommended that all departments adopt the systems making a brief narration of all activities that have been undertaken, plus costs incurred. It should not be left only to the Finance Manager to bring out expenditure reports.

II. Product and Strategy Development

- Loan portfolio is the largest asset that Faulu has and therefore when the portfolio quality worsens e.g. in this case a PaR over 30 days of 19.3%, it should be a matter of great concern to Faulu as the risk of not being paid is very high. The benchmark for MFIs is usually <10% since most loans are not backed by bankable collateral. There is an urgent need to understand reasons for worsening Portfolio at Risk and declining effective repayment rates and resolve them. Faulu should start with processing information from “Tuongee” forums and Suggestion boxes to understand new client demands and the nature of that demand.
- A great deal of Faulu’s resources is being drained in new recruitments, orientation and loan assessments as a result of high client exit. The remaining groups would be weaker groups that could easily disintegrate due to the absence of the values that held them together. Carry out a market research on client perception to find out reasons why Faulu lost 30% of their clients in 2003.
- Staff could be overwhelmed by the number and complexity of activities that took place within the Grant period including the measures undertaken to control the growth. Faulu should now consolidate the gains from the institution capacity building programme. A lot of systems are on the ground. There is a need to ensure that the internal systems work before implementing completely new programmes. Any programmes now implemented should strengthen the existing ones.
- In readiness for Deposit Taking, Faulu needs to have relevant infra-structures in place for deposit taking in terms of people, products, processes (including MIS), branch networks, and support organizations. USAID should support Faulu to understand the full requirements of a deposit taking institution e.g. through an institutional assessment to enhance institutional preparedness for deposit taking. USAID could also support Faulu to develop its staff and leadership in preparation for deposit taking
- Faulu Kenya and other similar MFIs in Kenya face the challenge of moving to the next level in terms of better innovative products that is clearly demand driven. As of today, competition is coming from commercial banks that have gone down market and offering services previously in the domain of MFIs. In as much as this is good for the industry, the MFIs need to envision the market better to understand and cope with this competition. USAID could support MFIs in general to understand changes happening in their environment. The starting point would be to work with the Association of Microfinance Institutions in Kenya to collect and disseminate data relevant to its members, including Faulu Kenya.
- USAID could support Faulu to understand the implication of its pilot BDS service before roll-out as this will have major implications for internal resources.

III. Management Information Systems

- This component posed major challenges for Faulu. There were cost overruns in the implementation of the current system. Detailed and structured planning of projects is recommended to ensure institutional needs are properly diagnosed and costs are properly controlled.
- FKL's disaster recovery plan (DRP), though existent, is not documented. The fact that the plan is not documented implies that FKL is over-reliant on the continued employment of the IT Manager and his personal recollection to manage disaster risks. FKL is at the stage in its growth when it should be focusing on building the institution and reducing reliance on individuals in order to safeguard institutional continuity. The DRP should be documented as soon as possible to facilitate delegation and continuity should there be a change in the IT Manager position.
- The large variations in the scope of the MIS related projects may be the result of insufficient work done at proposal stage in identifying and prioritising the institutional needs of FKL. Future projects of a similar nature to be funded by USAID Micro-PED should be preferably be within the context of completed, thorough and prioritised institutional needs assessment and a strategy that ensures the recipient of the funding has clearly thought the project through and understands their priorities and their strategic contexts.

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SECTION I: INTRODUCTION

1 Introduction

1.1 Background to Faulu Kenya Limited

Faulu Kenya Limited is a micro finance company registered in Kenya as limited liability Company under the Companies Act, and whose majority shareholder is Food for the Hungry International (FHI), a Bangkok, Thailand-based Christian relief and development organization with operations throughout the world including Kenya.

Faulu Kenya evolved from FHI project that started in 1991 as a pilot programme working with micro microenterprises in the Mathare slums east of Nairobi. It formally became the Faulu Loan Scheme in 1992 and officially became Faulu Kenya in October 1994. In 1999 it was registered as a limited liability company and today, Faulu Kenya is a sustainable and profitable micro finance institution offering financial services to Micro and Small Enterprises (MSEs) in urban and rural Kenya. Faulu is currently serving over 20,000 clients. Its total outstanding loan portfolio is over Kshs500 million. It has twelve Business Hubs (Units) spread across 27 districts in Kenya, and a staff of 118 members. A 7 member Board of Directors governs Faulu Kenya.

1.2 Project Context

By the time of its transformation into a legal entity in 1999, Faulu had considerably grown and was operationally self sufficient and well on course towards full financial self sustainability.³ To ensure its ability to continue providing services to an expanding market in a profitable and sustainable way, FKL needed to diversify its products, broaden target groups and increase its commitment to market approach – focusing on sustainability, professionalism and efficiency, while at the same time providing clients with appropriate and affordable financial services. However, in the year 2000, the board of directors were still newly composed and needed essential skills and competencies to run a commercial microfinance company while management needed to acquire adequate commercial skills to achieve targets and mentor junior staff. The staff needed training to cope with plans to diversify and offer a wide variety of products and to mentor and train clients. To cope with all these institutional changes, the organization needed to establish systems including management information system (MIS) to support growth that would be brought about by new products and structures. It was for these

³ The projections obtained from Microfin showed an operational self sufficiency level of 115% in Dec 2000 and a financial self-sufficiency of 85% for the same month.

reasons that Faulu Kenya sought a grant from USAID in May 2000 under the USAID/MicroPED project to achieve its growth objectives, including providing more microfinance services to micro and small enterprises.

Faulu Kenya Limited and U.S. Agency for International Development (USAID) co-signed an agreement, under the MicroPED Grant fund to the tune of USD430,450 to fund “Institutional Strengthening and Capacity Building Programme” for a two year period starting 28th February 2001 and ending on 28th February 2003. FKL was given a no-cost extension for a third year ending 28th February 2004.

1.3 Overall Goal and Specific Objectives of the Project

The overall objective of the project was *to improve the capacity of Faulu Kenya Limited to become a leading provider of financial services to further holistic nation and maximize stakeholder value*. The following four specific objectives were outlined in the programme proposal for achieving the project goal.

- *Strengthen the role of the Board of Directors through workshops and exposure visits;*
- *Develop human resource through training and exposure visits for management and credit officers;*
- *Developing new products and services, carry out active research on indigenous systems for micro-lending and savings; develop growth and market penetration strategies for existing and new markets; and strengthen lending procedures and operations; and,*
- *Upgrade the loan tracking system and improve management information system and establishing internal control systems.*

These objectives were to be met through lateral and top down approach where everyone in the institution, starting from the board of directors to customer support officers would promote the vision and mission of Faulu Kenya.

1.4 Purpose of Evaluation

The purpose of this final evaluation is to assess the effectiveness of the intervention against the aims and objectives as set out in the proposal and give the way forward. Specifically, the consultants were expected to:

- Assess the progress of the project in achieving its objectives;
- Assess the efficiency, effectiveness of the project implementation mechanisms;
- Determine the impact of the project on Faulu Kenya;
- Provide specific recommendations for Faulu Kenya and USAID that will guide the design and implementation of similar projects in future.

1.5 Evaluation Methodology

The evaluation was carried out in four main steps: review of applicable documentation and programme reports, formulation of questions to be used during interviews and discussions, discussions and report drafting, presentation of reports to Faulu and further discussions and finalization. Mrs. Ruth Odera of Microfinance House Limited and Messrs Gervase Odiko of Microde Consult and Francis Ogutu of Lattice Consulting Ltd conducted interviews at the Faulu head office and branches and at the offices of board members between 15th and 29th March 2004. The people consulted included: Human Resources Manager (who stood in for the Operations Manager), Chief Executive Officer, Chairman of the Board and one other board member, Internal Audit Manager, Information Technology Manager, Marketing and Business Development Manager, Finance Manager and officers from the Loan Tracking/Data Processing unit; Business Analyst, and one Area Manager. The purpose of these consultations was for collecting information required for the evaluation. A consultative meeting was also held with a key representative of USAID.

Project literature review was undertaken mainly at the Faulu Head Office but also in the consultant's respective offices. Several documents including proposals for the grant, reports, policy guidelines, work plans, etc was reviewed during the evaluation. A series of discussions with Managers were undertaken by the team: One consultant focused on the area of Governance, Management and staff development; another on Research and Development /service delivery system while the other on the use of funds impact of the project on FKL. The consultants met regularly to discuss, compare and contrast, and collate information received from interviews and document reviews.

1.6 Evaluation Team

Microfinance House Ltd won the bid to carry out the evaluation. It teamed up with two other consultancy firms Microde Consult and Lattice Consulting Ltd to conduct the evaluation. The team leader of the evaluation mission was Gervase Odiko of Microde Consult; he worked with Ruth Odera of Microfinance House Ltd and Francis Ogutu of Lattice Consulting Ltd. The evaluation started in earnest on 8th March and was completed on 31st March 2004.

SECTION II: ASSESSMENT OF IMPACT

2 Financial Performance and other Impacts

All sub-projects undertaken with support from the USAID Micro-PED grant eventually translated into financial performance. Therefore, a review of the changes in the financial statements over the last four years reflects the impact of all these components. The key financial objectives for the project were as follows:

Overall, the key financial impact of the project has been very positive, but it has also presented some challenges that FKL needs to address. Key outcomes of the project that are reviewed in the remainder of this section include:

- A significant improvement in the economic value added (EVA) by the company from a value-destroying position in 2000 to 2002, to a value creating position in 2003 – meaning that if this is sustained going forward, then the company is in a good position to raise additional commercial equity if it so requires;
- Rapid growth beyond Faulu's sustainable growth rate has led to significant improvements in profitability;
- Achievement of financial and operational sustainability;
- Consistent improvement in operational efficiency;
- A very positive and growing impact on job creation and stabilisation;
- A very positive impact on the board, leadership and board;
- A very positive impact on Faulu's capability to undertake new product development and refinement;
- Deterioration in the quality of the loan portfolio and regulatory exposure through funding advances out of the loan security fund (LSF).

2.1 Growth

FKL adheres to accepted accounting standards and its financial statements for the years 2000 to 2003 have been audited by Deloitte & Touche, who have given an unqualified audit opinion on them. The audit for the year ended 31 December 2003 was on going as at the time of this review.

FKL's profit and loss accounts and balance sheets for the past five years are set out in Tables 2.1 and 2.2 respectively below:

Table 2.1: FKL's profit and loss accounts (2000 to 2003)

	2000	2001	2002	2003
Status of accounts	<i>Audited</i>	<i>Audited</i>	<i>Audited</i>	<i>Un-audited</i>
Interest income	85,684	111,682	152,692	238,941
Interest expense	(6,953)	(9,216)	(20,834)	(25,948)
Net interest income	78,731	102,466	131,858	212,993
Fees and commissions	11,751	11,574	23,473	21,982
Foreign exchange differences	253	(824)	(368)	(2,171)
Other income	625	671	1,306	1,705
Operating income	91,360	113,887	156,269	234,509
Administration and operating expenses	(85,850)	(105,147)	(113,319)	(125,118)
Provision for doubtful debts	(3,192)	(3,339)	(8,537)	(13,164)
Operating profit	2,318	5,401	34,413	96,227
Grant income	22,859	20,886	13,723	7,313
Profit before tax	25,177	26,287	48,136	103,540
Taxation	(829)	(1,581)	(9,335)	(28,209)
Net profit for the year	24,348	24,706	38,801	75,331

During the period under review, net interest income grew 2.7 times from Kshs 78 million in 2000 to Kshs 213 million in 2003, largely as a result of portfolio growth. This growth represented a compounded average annual growth rate (CAGR) of 41% per annum.

Over the same period, profit before tax grew 4.1 times at a CAGR of 60% per annum from Kshs 25 million to Kshs 103 million. This was largely achieved because FKL's management was able to restrict CAGR in administration and operating expenses to 13% through various efficiency initiatives and human resources development.

What is not clear is the proportion of the portfolio growth that is attributable to macro-economic factors as opposed to FKL's strategic initiatives. Management is of the view that the rapid and significant growth experienced in the period under review is in large part due to the capacity building project, and to a lesser extent – exogenous factors in the industry. To be able to carry out an objective assessment of this, we would need industry-wide growth data, and this is lacking. .

Table 2.2: FKL's balance sheets (2000 to 2003)

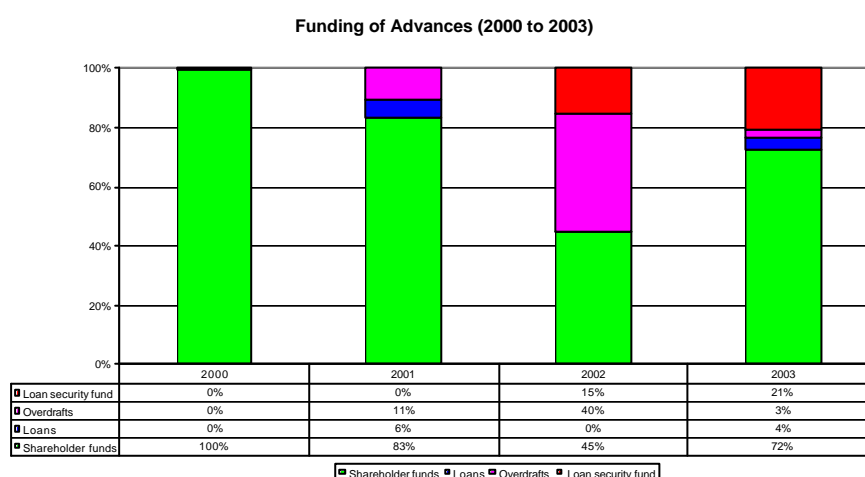
	2000	2001	2002	2003
	<i>Audited</i>	<i>Audited</i>	<i>Audited</i>	<i>Un-audited</i>
ASSETS				
Bank and cash balances	23,099	18,766	11,023	19,944
Short-term deposits with banks	45,562	65,821	93,623	116,926
Treasury bills	45,000	22,666	0	0
Government bonds	84,236	82,561	105,398	105,870
Advances to customers	249,163	329,130	693,876	532,889
Due from related organisations	8,724	6,799	985	(26)
Other receivables	12,060	13,342	18,061	19,045
Taxation recoverable	969	763	0	2,415
Deferred tax asset	371	1,616	5,548	5,548
Fixed assets	5,569	7,911	8,827	4,679
Intangible assets	188	633	3,606	9,818
Investment in subsidiary	0	0	0	1,828
Total assets	474,941	550,008	940,947	818,936
LIABILITIES AND EQUITY				
Liabilities				
Cash collaterals held	145,647	182,914	327,916	362,021
Overdraft	59,705	58,967	275,148	13,452
Loans	13,714	20,000	1,204	23,837
Taxation payable	0	0	9,949	15,781
Deferred income	938	4,213	7,048	7,138
Other liabilities	6,364	10,635	7,984	11,219
Total liabilities	226,368	276,729	629,249	433,448
Capital resources				
Share capital	100	100	100	100
Share premium	224,125	224,125	224,125	224,125
Retained earnings	24,348	48,672	85,932	161,263
Proposed dividend	0	382	1,541	0
Total shareholders' funds	248,573	273,279	311,698	385,488
Total liabilities and equity	474,941	550,008	940,947	818,936

Between 2000 and 2003, the total assets of the company grew 1.7 times from Kshs 475 million to Kshs 819 million (a CAGR of 20% pa). This was mostly financed by growth in retained earnings (grew by Kshs 137 million) and growth in client cash collaterals (grew by Kshs 216 million).

A fundamental principle of finance is that a company can only grow at its sustainable growth rate⁴ unless long-term financing, either in the form of equity or debt, is introduced. During the period under review, FKL grew faster than its sustainable growth rate (see table below), yet the company declared dividends when it needed to retain the dividends and introduce other forms of long-term financing to fund the growth. This would seem to indicate that the management was pursuing inconsistent objectives of providing a cash dividend to shareholders and financing rapid growth. We have, however, learnt that the dividend was a special arrangement to reimburse FHI for support received in the form of the loan tracking system that was inherited from them, and other forms of financial and technical support.

Table 2.3: Sustainable growth, portfolio growth and advances financed from the LSF

Year	2000	2001	2002	2003
Dividend payout rate	0%	2%	4%	0%
Sustainable growth rate	9%	9%	13%	24%
Growth in advances portfolio	N/K ⁵	32%	111%	-23%
% of advances funded by LSF	0%	0%	15%	21%
LSF financing of advances as % of total LSF balance	0%	0%	32%	30%



In 2001 and 2002, the company's advances portfolio growth rates were 3.5 times and 8.7 times its sustainable growth rates in the respective years. As a result, the company had to dip into the loan security fund to finance 21% of its advances in 2003 (2002: 15%). The advances financed out of LSF funds accounted for 30% of total LSF balances as at 2003 (2002: 32%).

⁴ Sustainable growth rate is defined as $(1 - \text{dividend payout ratio}) \times \text{Return on equity}$

⁵ N/K = Not known

As the chart shows, the company also adopted a short-term strategy of using overdrafts to finance the growth (up to 40% of the outstanding advances balances at the end of 2002 was financed using overdraft). This was not sustainable as it exposed the company's balance sheet to Asset-Liability mismatch risks. Management's view is however, that the average loan duration in their portfolio is six months, making overdrafts more suitable for financing their loan portfolio. Nevertheless, Management reduced overdraft financing as a percentage of total advances portfolio financing to 3% in 2003.

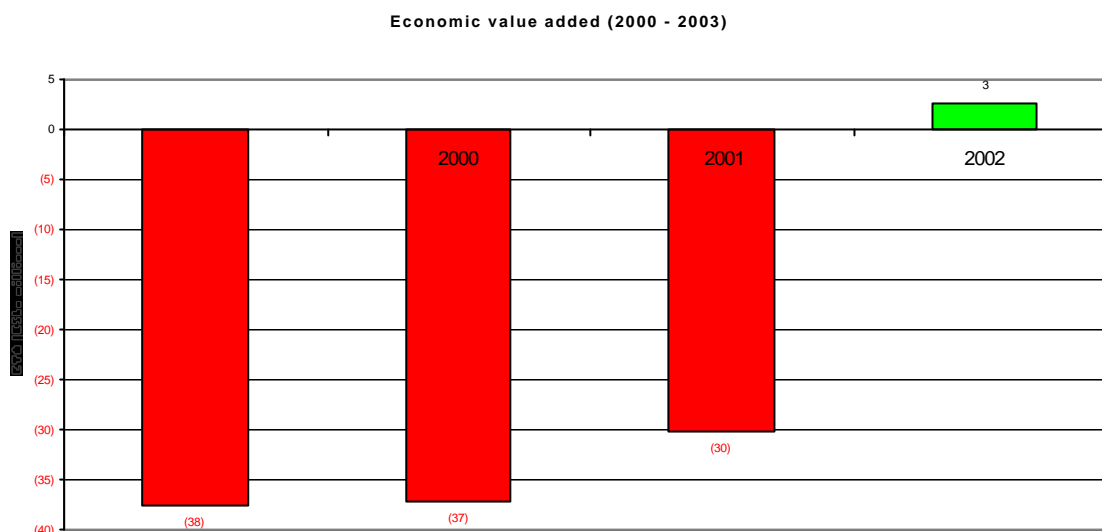
Management is, however, sensitive to asset and liability risks to the company and has set up an Asset and Liability Committee (ALCO) to manage asset and liability mismatch risks more proactively.

Although FKL is unregulated, financing advances out of the LSF could be in violation of the Banking Act that prohibits a non-holder of a bank licence from making advances from client deposits. Specifically, making advances from the LSF seems to be in direct violation of Sections 3 and 16 of the Banking Act. However, we have learnt that the management of FKL has discussed this matter with the Central Bank, and have been able to persuade the Central Bank to take a more lenient stance on the lending of LSF funds.

2.2 Economic Value - Added

The company has recorded significant improvements in the economic value (EVA⁶) it has added in the last four years. As shown in the graph below, the company has improved from a value-destroying position in 2000 to 2002, to a value-adding position in 2003.

⁶ Economic value is created when a company's assets generate returns that exceed its cost of capital (both equity and debt), and it is destroyed when the cost of capital exceeds the returns. In estimating the cost of capital, we have used the long-term observed required returns for equity investors on the stock exchange of 20% to 30% to estimate the cost of equity, and the after-tax cost of loan financing.



The positive economic value added in 2003 also indicates that for the first time, the company was able to generate a return on equity in excess of the company's cost of equity. The implication for this is that if this is sustainable, then going forward, FKL may be in a position to attract equity financing that is priced on commercial terms.

2.3 Financial sustainability

The Table 2.4 below summarises FKL's key financial sustainability indicators for the period 1997 to 2003:

Table 2.4: Financial sustainability indicators (1997 to 2003)

Indicator / Ratio	1997	1998	1999	2000	2001	2002	2003
Return on Performing Assets	28.5	33.2	28.0	25.7	24.2	25.2	33.1
Financial Cost Ratio	3.0	3.5	2.5	1.8	2.6	3.0	4.0
Loan Loss Provision Ratio	0.7	2.6	-	0.3	0.4	1.2	-
Operating Cost Ratio	49.1	39.8	33.1	22.3	19.7	16.1	18.6
Operating Efficiency ratio	112.0	60.2	46.8	33.8	35.5	24.4	27.5
Imputed Cost of Capital Ratio	32%	29%	18%	14%	14%	13%	7%
Donations and Grants Ratio	35.8	54.2	23.9	6.0	4.7	2.1	0.9
Operating Self sufficiency Ratio	54.8	76.6	78.7	105.3	106.6	124.1	146.0
Financial self-sufficiency Ratio	46.7	63.4	69.1	80.9	95.1	115.3	135.1
Portfolio Yield	33.3	40.6	35.0	35.6	37.0	38.3	55.3

The trend in the financial cost ratio shows the changing mix of funding to include third party commercial debt.

The loan loss ratio peaked in 2002 because of the introduction of new products in that year that the company's credit risk management systems were unable to cope with. This situation was rectified in 2003. The figure for 2003 is NIL because the figures above were pre-audit figures. Management has made a provision of Kshs 27 million after the audit.

The operating cost and operating efficiency ratios shows an improving trend in lending operations efficiency over the period. These ratios compare favourably to the average ratios for the African Medium sized MFIs at 103% and 95% respectively.

The decline in donations and grants ratio is a general trend in the industry, as donors withdraw funding from lending activities to capacity building type support. Further, as the MFIs transition to commercial entities, their dependence on donor support is reducing.

Consistent with our findings that Economic Value Added has been improving over the last 4 years, the company achieved financial self-sufficiency for the first time 2002 and consolidated this position in 2003. The company's operating and financial sustainability ratios compare favourably against the African Average for the Medium-sized MFI's (total assets greater than US\$5.3 million but less than US\$11 million).

2.4 Operating efficiency indicators

Table 2.5 below sets out FKL's key historical operational efficiency indicators:

Table 2.5: Operational efficiency indicators (1997 to 2003)

Indicator / Ratio	1997	1998	1999	2000	2001	2002	2003
Cost per Unit of Money Lent	0.43	0.21	0.20	0.16	0.14	0.09	0.14
Cost per Loan Made	10,984	7,078	7,434	6,023	5,499	5,146	9,303
Active Borrowers per DFO	101	186	142	170	190	277	224
Loan Outstanding per DFO (KShs '000)	1,683	4,358	4,288	4,540	5,516	11,300	7,953

Following conversion to a limited liability company from 2000 and the focus on a commercial focus, the company has made significant improvements in operational efficiency. However, there has been an abnormal increase in costs per loan in 2003 as a result of a 23% drop in the loan portfolio without a commensurate decline in costs.

The number of active borrowers per DFO has consistently increased to from 170 in 2000 to 224 in 2003. Despite the significant improvement, this indicator is still far below the average for the African Peer group at 423 cases per loan officer.

The loans outstanding per DFO have also increased consistently during the project period to a high of Kshs 7.9 million in 2003. The sharp increases in efficiency indicators in 2002,

followed by a decline in 2003 were attributable to a sharp upsurge in loan activity in 2002 following the launch of new products, followed by a scaling back in 2003 to manage the risks resulting from the sudden growth.

2.5 Portfolio quality indicators

Table 2.6 below shows the trends in portfolio quality indicators:

Table 2.6: Portfolio Quality Ratios (1997 to 2003)

Indicator / Ratio	1997	1998	1999	2000	2001	2002	2003
Portfolio in Arrears [Default Rate]	1.28	1.65	1.47	0.00	3.60	4.25	15.87
Portfolio at Risk	0.00	5.95	5.93	7.91	6.07	7.90	19.36
Loan Loss Ratio	0.77	0.24	0.00	0.97	0.02	0.00	0.00
Reserve Ratio	5.00	5.00	2.00	2.00	2.47	3.26	5.24
Effective Repayment Rate	94.78	92.68	92.00	85.00	79.00	80.00	43.21

The growth in business has been at the cost of a consistent and significant deterioration in the portfolio quality, especially in 2002 and 2003. Of considerable concern is the drop in effective repayment rate from a high of 94% in 1997 to 43% in 2003.

The deterioration in the quality of the portfolio has its origins in 2002 when a combination of factors led to weakened credit controls, amongst them:

- Launch of new products that were received very well by clients, without the complete protocol for rolling out the products being in place
- An upsurge in demand for FKL's loan products beyond what the company had planned that saw the case load per DFO almost double, and strained the institutions capacity to make good credit decisions.

FKL made a deliberate decision to scale back in 2003, leading to a 23% drop in the advances. This was to enable the company to address the issues that arose in 2002, and although the issues were fully addressed, the impact of the 2002 lending have shown up in 2003 statistics.

2.6 Impact on the Economy

Faulu estimates⁷ that three jobs are created for every 10 loans disbursed and 1.6 jobs are stabilised for every enterprise that borrows. The company also estimates that five people benefit for every client served and that of these five beneficiaries three are children.

⁷ Based on Food for the Hungry International guidelines

It is on this basis that the following impact indicators have been prepared:

Table 2.7: Impact assessment indicators (2000 to 2003)

Indicator / Ratio	2000	2001	2002	2003
Number of Jobs Created	4,629	6,115	8,232	5,798
Number of Jobs Stabilized	15,245	18,534	27,941	24,043
Number of People Primarily Benefiting	114,735	133,300	120,050	148,755
Number of Children Helped (included in above)	68,841	79,980	72,030	89,253

Source: FKL estimates

The number of jobs created and stabilised peaked in 2002, corresponding to the peak in loan disbursements, and dropped in 2003 when FKL decided to scale back loan disbursements. The movement in the number of people and children benefiting dropped in 2002 despite the increase in the loan portfolio because the increase was largely attributable to existing clients taking on multiple loans, rather than new clients being added.

Faulu Kenya continues to be sensitive to the role of women in development. At the client level, 47% of Faulu Kenya's clients are women. Faulu Kenya continues to record a steady increase in women leadership positions in the client groups in a culture that has had men predominant in these positions. At the staff level, 52% of Faulu Kenya's personnel are women.

2.7 Board Vision

It was found out that the various board retreats and corporate governance training workshops attended by the board members have greatly influenced the way Faulu Board of directors carries out its functions and responsibilities. All the board members now realise that they have to prepare for board meetings by spending time to read board papers: the board shares out work through the formation of special task committees (e.g. Executive Committee, Risk Management Committee and Internal Audit Committee). These committees prepare reports which they present to the board meeting for a discussion. This is a more efficient and effective way of operating than if the entire board had to do everything.

Faulu Board of Directors were found to have a clear vision of where Faulu would like to be in the long run. The board members talked concurred that over the next five years, they wanted to see Faulu being:

- A 10 billion company
- A company that offers business development services over and above the financial services currently offered

- A company that serves the community in a holistic manner, e.g. concerned about health and environmental issues including HIV AIDS.
- A company that works on the development of leadership of integrity (albeit quietly)

The board members were clear that their role was to lead and guide the management including setting the targets to be achieved by them while the management runs the affairs of the company on a day to day basis. This was not the case in the past as the board chairman was very close to company's day-to-day operations. Individual board members also set targets for themselves and what they would like to achieve over a given period (usually a year). The board members have developed performance evaluation tools for its members. Every year, the board members go through a peer evaluation exercise whereby each member carries out a self-assessment by filling out the evaluation forms indicating how in his/her opinion s/he has performed. This is presented to the rest of the team for comments.

2.8 Management Systems

2.8.1 Management Information System (MIS)

The impact of the LTS project on FKL has been very positive it has enabled FKL to cope with the rapid growth in the last three years, something that the previous system would not have been able to do as it was tottering on the brink of collapse.

There is improved the internal control environment as the systems facilitate data validation checks and enables audit queries to be run on it by the internal auditors. There is, however, still further work needed to be done to fully develop the systems ability to support the internal audit function

2.8.2 Human Resources

Activities carried out for staff development implanted a strong conviction among staff who took part in the study tour that "it can be done." Apparently, before the study tour to Bangladesh there were doubts among some frontline staff as to whether the poor can be served in a profitable manner. Staff who attended the Frankfurt training reported better understanding of the microfinance sector, the current issues and confidence of putting Faulu on the world map of microfinance. The activity conducted instead of the staff motivational survey, letters to the management followed by a long meeting that acted as safety valve and restored confidence of staff in the management thereby boosting their morale.

Confidence, conviction and better understanding of the microfinance sector all affect positive the manner in which one works.

3 Finance, Audit and Monitoring

3.1 Objectives and Activities

The key financial objectives for the project were as follows:

- To achieve financial self-sustainability
- To perform at a level capable of attracting financing from the capital markets.

It is important to note that whilst activities in other parts of the organisation (such as offering new products, and efficient delivery mechanisms) were expected to contribute towards these objectives, the Finance Departments specific planned activities towards meeting these objectives were:

- To evaluate the adequacy of the system of internal control, policies and procedures in line with the growth strategy of the firm
- Training and exposure of the management and finance departments staff for improved capability in finance raising
- To implement a cost/profit centre model
- To establish and develop bank relationships.

Additionally, specific planned activity for the USAID Micro-PED project included 2 annual statutory audits (for FKL as a whole), 2 USAID audits (for the project only) and 2 monitoring/evaluation reviews (for the project).

3.2 Progress achieved against planned activities

To strengthen internal controls, the finance department and internal audit staff has been sent on an ICPAK organised fraud detection course. Other courses that the department's staff has attended include:

- Microfin training – for financial modelling
- Tax courses
- ICPAK continuous education courses.

The implementation of a cost/profit centre model has started with the splitting up of the branches into distinct reporting entities, as enabled by the MBWIN system. Reporting by branches has also been possible but the preparation of the branch reports is tedious, takes long, and the reports are not available on demand. Progress has been hampered by:

- The inflexibility of the DOS-based SunSystems. This system is not able to allocate shared overheads between the cost/profit centres, requiring tedious additional computations to be done outside the system to achieve this. It is expected that this will be possible to achieve with the Microsoft Great Plains Financial Management System

- The lack of integration of systems, which still requires manual analysis and posting from one system to another – this will be addressed by the company's plans to integrate the different components of its MIS.

Currently, all but one of the branches is profitable. The exception is the Mount Kenya branch that was recently split up into two units, and needs to rebuild its client base before it can achieve profitability.

On relationships with banks and other providers of debt capital, a lot of progress has been achieved:

- The company has been able to attract a US\$450,000 18-month loan from Blue Orchard, an international lender to MFIs at a pricing of LIBOR + 6%. It is instructive that Blue Orchard approached FKL with the offer for financing, rather than FKL approaching them.
- The company is in the last stages of preparation to issue a KShs 500 million bond in the local money market. This bond will be facilitated by a 75% partial guarantee from AFD Bank of France, and is expected to be priced at 6% to 7% interest rate per annum
- FKL is in the final stages of negotiation with the Co-operative Bank for a KShs 150 million loan facility, that will be facilitated by a 50% partial guarantee from USAID, through the DCA

On audits and evaluations, there were errors in the initial project proposal as follows:

- FKL erroneously believed that it could pay the cost of annual statutory audits out of the project funds, but this turned out not to be in compliance with USAID regulations
- According to USAID regulations, projects spending less than US\$300,000 a year do not need to carry out an audit and project evaluation as defined by USAID, instead, financial and project reviews are adequate.

For this reason, no statutory audits have been funded from the project (although they have been carried out annually). Similarly, only one post-project closing financial (currently underway) and one project review has been undertaken.

3.3 Recommendations for Faulu

Issues identified	Implications	Recommended actions for FKL
LSF funds are advanced to clients	Technically a violation of the Banking Act and despite management's assertion to the contrary, could expose the company to CBK penalties.	FKL should expedite alternative financing initiatives to ensure that client collaterals are not used to fund advances
The company seems to have not anticipated the full extent of the growth that was experienced in 2002.	The company needs to enhance its business planning ability and pursue a policy of controlled growth. This is more so, going forward into the regulated regime where uncontrolled growth and its implications for capital adequacy and other regulated parameters could lead to penalties.	Proactively control growth and improve ability to anticipate the future.

3.4 Recommendations for USAID

Issues identified	Implications	Recommended actions for USAID
Sector-wide data is hard to come by	Benchmarking locally and industry wide trends are not clear. This makes assignments such as this review difficult because it is difficult to isolate exogenous factors that affect the company's performance.	USAID should consider supporting an industry database, preferably to be maintained by AMFI. This will facilitate reviews such as this, facilitate industry studies and allow competitive benchmarking to take place amongst players in the industry.

SECTION III: ASSESSMENT OF PROJECT RESULTS, EFFECTIVENESS AND EFFICIENCY

4 Governance Development

Overview information about the board

FKL Board of Directors is composed of six members, one woman and five men. All the board members are professionals from the private sector but without prior knowledge of the microfinance sector. All the board members bring in different types of skills to FKL. The Board has no recruitment committee but the Executive Committee scouts for new board members using set criteria including that the person must be a team player, independent minded, able to express and stand by his opinion but be able to accept consensus. The new board member must be bringing in some additional skills. The board term is four years renewable once, so one can serve for a maximum of 8 years on the board.

4.1 Objectives and Key Result Areas

The objective of this component as stated in the project agreement is to “*Strengthen the Role of the Board of Directors through Workshops and Exposure Visits*”. It was anticipated that the key result by the end of the project would be “*FKL mission and strategy clearly articulated and lived out by the Board of Directors and Management Staff*”. The vision is stated as “... *one nation where all people are able to work toward fulfilling their dreams and potential for the future and have the dignity of being able to provide for their own needs and the needs of others*”, while the mission of Faulu is stated as “... *to be a leading provider of financial services to further holistic nation building and maximise shareholder value*.” The strategies adopted by Faulu to achieve its vision and mission include moving from operating as an NGO to a fully commercialised microfinance company operating country wide. In order to achieve the key result, some immediate objectives laid out included to:

- Prepare the Board of Directors to provide better governance
- Prepare the managers (and other staff) to operate in a private commercial institution.

4.2 Progress achieved against objectives

Workshops for enhancing governance

It was found out that Faulu Board of Directors are well trained in corporate governance and are informed on matters relating to microfinance. All the members of the board except the newest member have undergone training in corporate governance. The training courses were spread out such that not all the directors attended the courses at the same time. Two members attended the training course in October 2001, one in October 2002, one in December 2002 and another one in March 2003 (five members of the board). Although the newest board member has not undergone the corporate governance training, it is the FKL Board policy that all board members must undergo corporate governance training at the Centre for Corporate

Governance and be Certified Directors of the Institute of Directors, Kenya. The new director will therefore get a chance to be trained at the Centre. The formal corporate governance training courses were all conducted by the Centre for Corporate Governance.

Workshop for visioning

It was established that Faulu board members have a clear vision of where Faulu should be in the long-run. It was established that the Faulu Board of Directors goes for retreats every year. As a way of enhancing its corporate governance, competence and capabilities, the Board has a policy of using these retreats both as training forums and as forums to strategise for the way forward. During such retreats, therefore, guest speakers or facilitators have been invited to facilitate on corporate governance or board decision-making process. At the annual retreat of August 2001, a leading corporate manager in Kenya, Mr. Titus Naikuni (Managing Director, Kenya Airways) was the guest speaker/facilitator.

In the year 2003 Faulu turned 10 years old. To mark the anniversary, the board had a special team building retreat dubbed “Blue Sky Session”. The idea was that each director was supposed to look at the sky and dream about the future of Faulu and share his or her dreams with the rest of the directors. This led to the formation of the strategy for the next five years. It was emphasised that such sessions were used to sharpen the Faulu Vision/Mission but not to change them.

Board of directors’ handbook

The board has developed a Board of Director’s Manual as was anticipated at the beginning of the project. The manual has chapters on Faulu as a company; the purpose and responsibilities of the board; board members’ functions; structure, systems and style; training, development and compensation and relationship. Under relationships such subjects as board members’ relationship with the chairman and amongst themselves, relationship with the General Manager, management and staff among other topics have been discussed. Under systems, the following issues have been discussed: board meetings, frequency of board meetings, board meeting agenda, board information and decision-making.

The evaluation team was informed that the Centre for Good Governance had a look at the handbook and gave some useful comments that helped improve the document. This document is a great idea and puts Faulu ahead of other companies, as many companies in Kenya do not have directors’ handbooks.

4.3 Efficiency of implementation

To measure efficiency of an implementation process, one needs to compare plans and achievements, and whether the implementation of activities was timely or delayed. The evaluation team was not able to find any quarterly plans for the board and staff. Likewise there were no narrative reports describing the implementation progress. There were only financial reports to USAID. This made it difficult to measure efficiency in the implementation of activities.

4.4 Effectiveness of the implementation

The effectiveness of board training can be gauged by the manner in which the board conducts its affairs now as opposed to manner in which its business before. During the evaluation, the team saw signs of improved efficiency in the manner the board conducted its affairs. The board recently set up committees: Executive Committee, Risk Management Committee and Internal Audit Committee. These committees are accorded specific tasks and they report to the board during their meetings.

It was also found out that board members go to meetings more prepared. This is because they have realised that to participate effectively in board meetings, they have to take time and read board papers before board meetings. The meetings are characterised by informed discussions, are professional, brief and to the point.

5

Leadership and Staff Development

5.1 Objectives/Key Result Areas

The objective of sub-component was to develop human resource through training and exposure visits for management and credit officers.

5.2 Planned Activities

The following activities were planned to achieve the objective:

- Develop staff training curriculum
- Undertake in-house staff training
- Staff study visits to MFIs in Asia, Latin America and Africa
- Staff external training in Boulder/Frankfurt
- Increase the proportion of productive operational staff from 40% to 70% by December 2001
- Conduct staff motivation survey

5.3 Progress achieved against objectives

Develop Staff Training Programme

The project proposal indicated that staff training curriculum would be developed, however, it was explained that what was to be developed was a training programme and not curriculum. The Human Resources Department prepared a training calendar for the year 2001. The programme was quite detailed and indicated the name of the course and when it would be offered, and in some sections, how much it would cost.

There were however no similar training programme for the years 2002 and 2003. The explanation given for this is that there had been a rapid growth in the portfolio and there was a shift of focus from training to loan repayment monitoring.

Undertake In-house Staff Training

Several training courses were conducted where all the staff participated during the project period. Such training included induction training for new staff that covered topics on group dynamics, business training and loan policies and procedures, Customer Care, Default Management. Generally these areas are critical for the operation of MFIs. All new staff must undergo training in these.

Conduct Study Visits to MFIs in Asia, Latin America and (other countries) in Africa

During the life of the Faulu Capacity Building project, the CEO and the Chairman of the Board of Directors made a study visit to Washington DC as guests of the World Bank. One of

the newer members of the board accompanied staff for an exposure visit to Bangladesh. While in Bangladesh, the Faulu team visited the leading Asian MFIs like BRAC, Grameen Bank, ASA and Buro Tangail. They noted that whereas Grameen was focused on microfinance lending, BRAC had a more holistic approach and had other programmes like in health. BRAC even runs a University. One major lesson learnt from ASA was the importance of keeping operations simple and standardized and therefore the need to encourage and ensure that staff adheres to operations manuals and guidelines. Other ideas that were reinforced were (a) the need to cap client loads for DFOs; (b) market segmentation for right product delivery; and (c) care in replication as poverty levels as contexts differ.

Conduct External Staff Training in Boulder/Frankfurt

The Microfinance Summer Academy Course conducted in Boulder/Frankfurt, Germany is a two-week microfinance course offered during summer of every year. The institution offering the course is part of the Deutschbank College. It is an international course attended by people from many different parts of the world and facilitated by prominent personalities from microfinance sector. Since 2001, two members of FKL staff have attended the course; one in 2001 and another one in 2002. Some of the topics covered in this course include:

- How to manage microfinance institutions
- Leading changes in microfinance market
- Product development
- Cost management
- Risk management, among other topics

Staff talked to felt this was a great course that made one see the “big picture” of microfinance industry. The course also exposed and removed the participants from their cocoons making them realise that what they do is not necessarily the best.

Increase the proportion of productive operational staff from the current 40% to 70% by December 2001.

According to the information received from Human Resource Department, at the time of the evaluation, Faulu had a 114 strong staff out of which 30 were Business Support Centre staff members while 84 were field staff. This means that 74% of the work force was field staff. This means that the restructuring recently carried helped Faulu achieve the objective of raising proportion of field staff to above 70%.

Conduct Staff Motivational Survey

A survey as is conventionally known was not carried out, however staff members were asked to write unsigned letters to the management raising what ever issues they thought needed to be addressed. Staff responded well and a meeting to discuss the emerging issues was called. After the meeting, it was felt that all the contentious issues were adequately addressed thereby raising staff morale.

5.4 Effectiveness of implementation

The purpose for human resource development was to, among other things; prepare the management and other staff members to operate in a private commercial institution. This meant not just acquiring technical skills to function, but also changing the thinking of staff from welfare/relief type of operation. MFIs with NGO background have found this a big challenge as staff members tend to continue to have a non-profit attitude.

Study visits to successful MFIs in other continents were found to be a major eye opener to staff. Some of the staff talked to were shocked at the level of poverty in these places and were equally very surprised that people can do so much, on their own about their own poverty and therefore the determination that “we (Faulu) can also do it”. The visits also made the staff realise that serving the poor in a profitable way is not just a Faulu talk but something being done successfully in other continents with even higher level of poverty.

External training, especially in internationally recognised institutions like the Frankfurt Summerakademie was found to be effective in making staff see the bigger picture of the microfinance industry. It had the effect of making staff see where Faulu is vis-à-vis the other MFIs in the world.

These activities were found to have contributed to changing staff thinking and attitude.

5.5 Efficiency of implementation

The external training, the study visits and other staff training were planned for carried out according to plan. The study visit to Bangladesh had representation from all cadres of human resources; DFOs, middle management, senior management and even one board member. This is very commendable as doubles up as a team building activity. This was therefore found to be an efficient use of resources.

5.6 Recommendations

Board of Directors’ Manual:

It is commendable that this document is place in Faulu, however, it the experience of the consultant that many times such documents are produced and then kept in the shelves. To avoid this, *it is recommended that the board considers reviewing the manual as a permanent agenda item for the annual board retreats.* This would serve two purposes: one, it would ensure that all board members are continuously up to date with the expected performance of each board member, two, it would ensure that the document “stays alive” as the document would be reviewed continuously.

Documentation:

It is recommended that Faulu improve in its documentation. When seeking to know the training courses attended by the board, there were no records apart from the financial records. Information had to be extracted from payment records. Likewise, there were no training reports. It is common practice in many organisations that where a training course has been conducted, a training report is produced. Such a report would contain information on when the training was conducted, where it was conducted, who participated, the highlights of the course contents, training evaluation by participants or beneficiaries and how the training progressed generally. Because such reports contain course outlines and evaluation reports the participants, they would help Human Resources Department design future training courses to offer to staff in future.

There is a need to document “Back to Office” reports after cross visits and make them available to other members of the board and/or staff of the institution.

Progress reports

Then evaluation team was not able to trace any reports detailing project implementation progress reports. This an import monitoring tool. *It is recommended that financial reports be accompanied with a narrative showing the implementation progress, problems encountered and how they were overcome and any lessons learned.*

Exposure Visits

It is recommended that local (within Kenya) exposure visits should also be undertaken as this can be very cost effective. There are many aspects of microfinance practices that Kenyan MFI can learn from each other.

6

Product and Strategy Development

6.1 Objectives/Key Result Areas

The objectives of this component were: *(a) develop growth and market penetration strategies for existing and new markets; (b) carry out active research on indigenous systems for micro-lending and savings; and (c) Develop new products and services.* (The key result of this component was expected to be *“FKL systems established to effectively and efficiently achieve the mission and strategic goals of the company”*). This key result area would support the achievement of the following strategic objectives of FKL:

- To expand Faulu Kenya into an effective multi-unit, financial services intermediary, able to provide financial services to micro and small enterprises (MSEs) on cost covering, sustainable and profit basis;
- To increase both agricultural and non-agricultural employment and self employment opportunities, especially for low-income people, through increased productive capacity; and
- To provide increased access to financial services for low-income people in Kenya, who are disenfranchised from mainstream commercial banking and financial sector.

6.2 Planned Activities

Under product development strategy, Faulu planned to carry out the following activities
(a) Develop appropriate tools for carrying out the assessments and the training of staff in the analysis of findings, and carry out market mapping in existing and new markets (c) research its client profiles (c) develop product and services development toolkit (b) set up research and product development department (d) carry out active research on indigenous systems for microfinance lending and savings (e) develop growth and market penetration strategies for existing and new markets (f) develop a system of client progression within Faulu (f) carry out full costing of products and services

6.3 Achievements against objectives

Develop growth and market penetration strategies for existing and new markets

Faulu Kenya was able to develop growth and market penetration strategies for its existing and new markets through various activities that included a socio-economic survey to understand client profiles, research on dropouts to understand underlying factors for dropping out, market research to understand current and potential customer needs, research to profile and understand Faulu's competitors, and customer survey to understand customer satisfaction.

The socio-economic survey was undertaken by staff of Marketing Department in December 2001. Its main objective was to bring out client characteristics which would enable Faulu to

develop market segmentation strategies for product positioning. The survey covered 8,581 clients (made up of 46% women and 54% men) from the 5 business units and provided client profiles by gender, locality, business sector, socio-economic class, loan cycle, level of education and loan type. Faulu staff also undertook research of Faulu dropouts to find out and track information on why clients were leaving the programme and what they think about the programme. Results from the dropout study revealed issues related programme design, client personal and business reasons, group related reasons and product methodology. The findings of both studies were documented and used to streamline specific needs for clients during the development of new products.

Faulu has developed in-house capacity to carry out market mapping through Area Market Mapping (AMA). This tool was developed and refined by Faulu and has been useful for obtaining strategic information for penetrating existing or completely new operational territories. The tool is used analysing market-mapping exercise carried out by DFOs as part of the market entry activities. Using the tool, DFOs can analyse information and reasons as to the most potential area and groups for expanding market; and priorities that should be set for different types of groups. The tool is now part of the Loan Policy and Procedures Manual. The tool has various steps a DFO should take to gather market information on competitors and local and social dynamics.

Develop new products and services

According to the proposal for the Grant, FKL was to *develop, test and launch two new loan products within the grant period*. However, the product development consultancy undertaken by Fineline Systems and Management Ltd in collaboration with a team from FKL in 2001 developed eleven prototypes. Among these products was the refined working capital loan which had been very popular with micro/small-scale entrepreneurs and considered the company's flagship. FKL branded and rolled out five products: three business loans and two consumer loans briefly described below.

Pamoja is the basic business loan for working capital for first-time micro and small-scale business clients previously without experience with formal financial services. *Pamoja* loans starts from Kshs1000 and capped at KShs100,000 and repayable over 12 months. *Fanaka* is also a working capital loan for existing clients who have successfully serviced at least two⁸ *Pamoja* loans and wish to take a third or subsequent repeat loan of Kshs 100,001 – Kshs 500,000. *Fanaka* loans were repayable over 18 months. *Fanaka Plus* is a loan product for relatively bigger growth businesses which enabled the “Jua Kali” enterprises excluded from

⁸ Although *Fanaka* Loans and *Fanaka plus* Loans were meant to be for graduated *Pamoja* groups these loans are now all business loans for clients that meet the conditions and requirements for Faulu Kenya.

financial services by both microfinance and mainstream financial institutions to access credit in smaller self-selected groups. Fanaka plus loans start at Kshs 500,001 and caps at Kshs 1,000,000 and is repayable over 24 months. *Elimisha* loans is a school or college fees loan with a maximum of Kshs 50,000 repayable over 12 months while *Mara Moja* is an instant 6-month loan for emergencies, also capped at KShs 50,000. Loan terms and conditions are given in Table

Table 5.1: Loan terms and conditions

ATTRIBUTE	PAMOJA	FANAKA	FANAKA PLUS	ELIMISHA	MARA MOJA
LOAN SIZE RANGE	1-100,000	100,001-500,000	500,0001-1,000,000	Kshs 1-50,000	Kshs 1-50,000
INTEREST RATE	18% reducing to 16% and to 15% upon achieving perfect repayment rates	18% reducing to 16% and to 15% upon achieving perfect repayment rates	18% reducing to 16% and to 15% upon achieving perfect repayment rates	2% flat rate per month	2% flat rate per month
LOAN TERM	3,6,9,1215,1821, 24	3,6,9,12 months	3,6 months
GRACE PERIOD	2 or 4 weeks	2 or 4 weeks	2 or 4 weeks	2 or 4 weeks	2 or 4 weeks
REPAYMENT OPTIONS	Weekly, 2 weekly, 4 weekly	Weekly, 2 weekly, 4 weekly	Weekly, 2 weekly, 4 weekly	Weekly, 2 weekly, 4 weekly	Weekly, 2 weekly, 4 weekly
LOAN PROCESSING PERIOD	10 working days	10 working days	10 working days	10 working days	5 working days from
Collateral	Group Guarantee non-traditional assets like household and business	Group Guarantee Moveable and fixed assets (e.g. land, motor vehicle and company shares)	Group Guarantee Moveable and fixed assets (e.g. land, motor vehicle and company shares) Business/Industrial		

Embodied in the management of business loans was a *client progression system* where clients could start with relatively small amounts and graduate to bigger loans. This ensures that loan terms are matched to client needs and desires.

The pricing of new products i.e. interest rate setting was done after a full costing exercise that was preceded by a review of Faulu's service delivery system, the estimation of level of efficiency and analysis of cost per service. The costing exercise included an analysis of overhead costs and those related to implementation, disbursement and monitoring of solidarity group activities. The areas of high expenditures were revealed and highlighted for

action. The costs at the time of product offer reflected the true value of the products and associated costs.

Research on indigenous systems for micro-lending and savings

Research on indigenous systems for micro lending and savings was done as part of the product development exercise. As a result, a loan product for financial cooperatives and associations branded Ushirika was developed and will be tested at an appropriate time.

6.4 Effectiveness of project implementation mechanisms

The effectiveness of a project can be gauged in relation to the contribution made by results to the achievement of the project purpose, and how the assumptions have affected project achievements. Effectiveness is also gauged by the utilization of resources to achieve the results. It is usually assumed that the contributions of projects are thought of in advance before the start of the project.

Markets and Products

Over the past three years, Faulu Kenya Limited has built up a strong market position in 12 business hubs (Central Nairobi, East Nairobi, West Nairobi, Ngong Road, Jogoo Road, Thika, Pumwani, Machakos, Nyeri, Meru, Nakuru, and Molo). It is a market leader in microfinance reaching over 20,000 clients and whose wide range of products meets a variety of needs of its original target group who are the economically active poor persons unable to access bank loans.

Utilization of resources

The product development exercise involved not only contracted consultants but also an internal team from different parts of the organization representing their departments. The team was composed of personnel from marketing department, finance, information technology, operations, human resource and branch representatives and field officers. The use of internal staff as part of the team during the market intelligence and customer survey, prototype development, and launching of the new products enabled Faulu to build in a strong in-house capacity for product development or refinement. Faulu is now able to respond adequately to client needs through its activities in the Marketing and Business Services Development Department.

6.5 Efficiency of project implementation mechanisms

The efficiency of a project is gauged by whether the results were obtained at reasonable costs, how well the means and activities were converted into results and the quality of results achieved.

Under the component of research and development, the implementation of the project mechanisms could be said to have been efficient. This is because: (i) most of the original work plans starting from the assessment and analysis of Faulu Kenya market and clients, and product and strategy development were complied with and at times, the institution surpassed its targets. For example, according to the proposal, 5 loan products were developed and rolled out instead of 2 new loan products. (ii) Costs through which the component was done were reasonable. The estimated person days of complex product development⁹ using MicroSave-Africa qualitative research tools is 104 days at an estimated cost of USD37,000. FKL used USD39,443¹⁰, which is 83.2% of the budgeted amount. The cost of this exercise is therefore in line with industry-wide costs for product development. The various activities carried out for the Research and Development component were relevant and the resources used were adequate for the activities.

The process of carrying out the product development activities were professional and adequate as they led to the launching of 5 new/refined products which has enabled FKL to grow tremendously within the Grant period. The consultancy, through which the activities were carried out, was awarded to Fineline Systems and Management Limited, a consultancy firm specialised in providing strategic advice, technical assistance, and training to institutions involved in microfinance and small enterprise development whose in-house staff and associates have the accreditation from MicroSave Africa and the expertise to undertake this activity.

⁹ Graham A.N. Wright “Market Research and Client-Responsive Product Development” pp 11

¹⁰ For customer and market intelligence survey of the Kenyan Microfinance sector, training and discussion workshops between the consultants and Faulu Kenya, review of FKL service delivery systems and costing per service, design and development of product prototypes, revising policies and procedures manual, developing marketing market positioning strategies, reviewing of lending operations and costing and pricing of new products.

7.1 Key Result Area

As stated in the results framework, the key result of this sub-component is “FKL systems established to effectively and efficiently achieve the mission and strategic goals of the company.

7.2 Objective

The objective of this sub-component was to strengthen lending operations and procedures.

7.3 Planned Activities

Faulu planned to (a) re-allocation of some of its business units (b) review basic lending operations to speed up its operations e.g. loan approval and disbursement.

7.4 Achievement against objectives***Re-allocation of business units***

Discussions on re-allocation of business units in Faulu would not be complete without discussing in what institutional structure Faulu launched the five products and what were the challenges and effects of growth.

Before New Product Development (2000-May 2002)

Faulu's structure before the launch of the new products was more appropriate for a growing organization. The structure was responsive both to clients and employees and could allow Faulu to learn the needs of the clients and respond to them. It was a flat structure where the customer, markets and customer services personnel were the central focus for all their activities and the rest of the functions served the core business. The strategic business team, composed of the Chief Executive Officer, Business Unit managers, Operations Manager, Finance Manager and Marketing Manager were constituted to give business direction and support to business units (branches). This structure was appropriate as it tended to minimize walls of communication and encouraged the participation of staff across boundaries of departments.

Faulu's organization systems and resources including human resource, management capability to serve the market well, policies and procedures could only serve adequately, its current clientele. It had a one main product which was also the flagship of the organization – the Working Capital Loan financing needs for working and expansion capital of micro/small-scale enterprises and two other products (Family Need Loan and the Fixed Asset Loan) which had performed poorly in the market due to certain factors. The available strong staff of 110, 64 of who were Development Finance Officers could easily cope with the workload and client demands.

Even before the launch of the new products, Faulu had planned to re-allocate its business units to localities that are customer friendly and to decentralize its basic lending operations to speed the response to customer needs/complaints. This decentralization would pose major administrative challenges to Faulu in ensuring that the institution is not over duly exposed to portfolio deterioration and standard processes are implemented consistently in all the branches (hubs).

Fast Growth and Expansion (May 2002 – July 2003)

When Faulu rolled out the five products in May 2002 and many existing clients took up multiple loans that strained their business beyond their capacity to pay. Many new borrowers were recruited as well leading to additional clients leading to the rapid increase in the outstanding portfolio by the end of 2002. The increase in clients caused a heavy strain on the internal system which compromised the ability to supervise, to monitor loans and manage risks. The results are discussed below:

a. Deterioration of Portfolio Quality

FKL portfolio quality deteriorated to an all-time low of 19.36% in 2003 from manageable levels in 2001/2002. Similarly, the effective repayment rate (ERR) reduced by nearly half from 80% in 2002 to 43% in 2003.

Table 6.1: Portfolio Quality (1999-2003)

	1999	2000	2001	2002	2003
Outstanding Loan Portfolio (Kshs '000)	167,340	245,126	321,872	709,529	545,935
Portfolio at Risk (PaR28)	5.93%	7.91%	6.07%	7.9%	19.36%

Figure 2: Portfolio Quality (1999 – 2003)

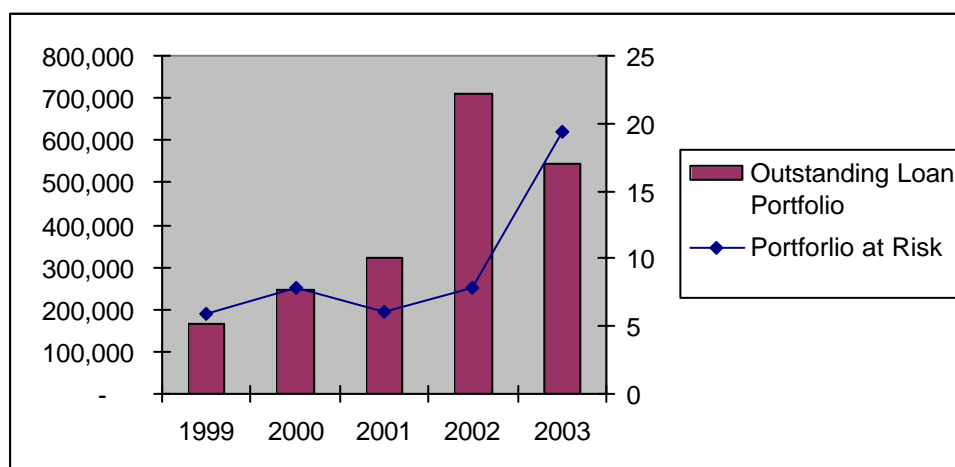
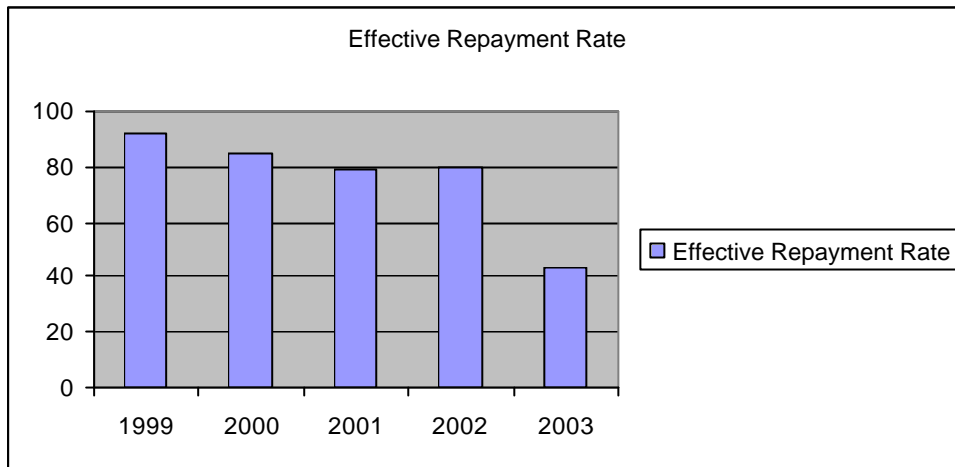


Figure 3: Portfolio quality (1999 – 2003)



The increasing levels of portfolio at risk and the decreasing effective repayment rates showed that the rate of expansion exceeded the management's ability to serve the market well, either in managing risks or in supervising field staff.

b. High levels of client exit

Faulu lost one fifth of its clients in 2002 and one-third in 2003 nearly one and half years after introducing new products. This was not healthy for Faulu as this drains resources and may lead to weaker groups that could easily disintegrate for lack of cohesion. These very high levels of exit could be attributed to but not exclusive to either a dissatisfaction of clients with FKL and dissatisfaction with product offer.

Table 6.2: Client Exit in Faulu (1999-2003)

	1999	2000	2001	2002	2003
Number of registered clients	10,867	14,965	18,696	24,010	20,804
Percentage of clients exiting the programme	23%	18%	17%	18%	30%

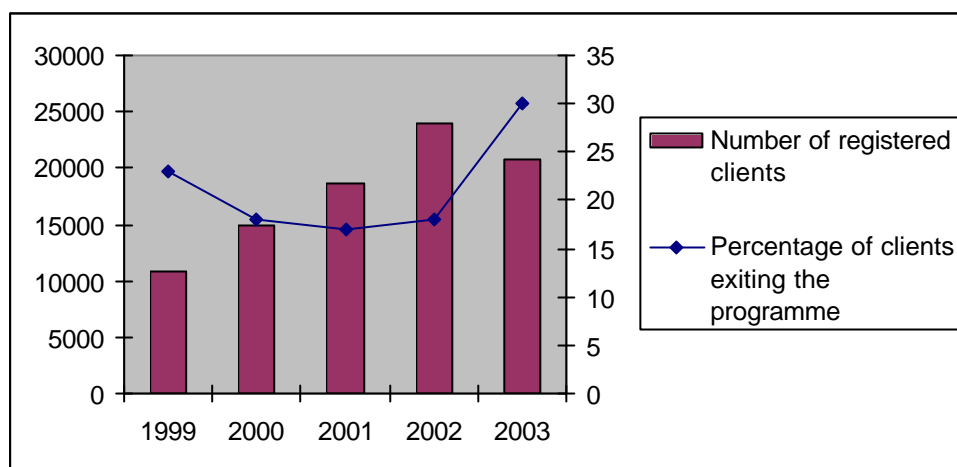


Figure 4: Client Exit in Faulu (1999-2003)

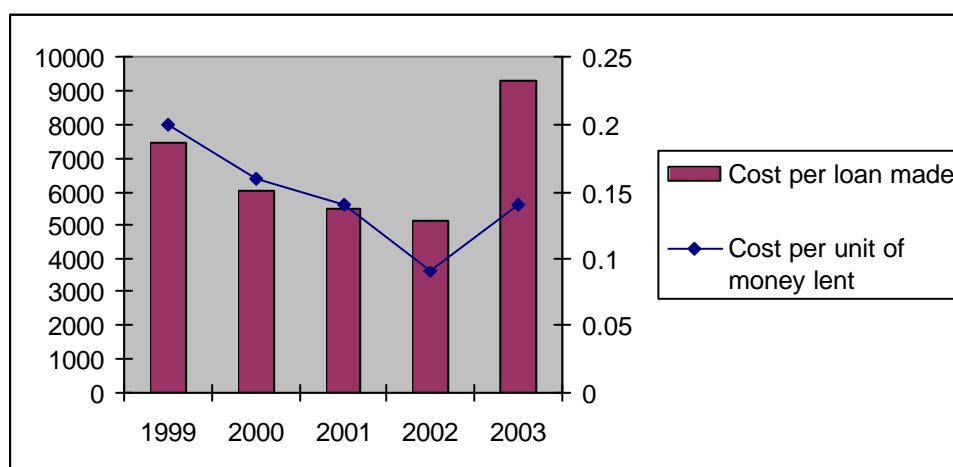
c. Cost of lending increased

The cost of lending increased between 2002 and 2003 possibly due to the high number of new borrowers in the portfolio who had smaller loans leading to decrease in per unit return or average cost per shilling.

Table 6.3: Cost of loan made and shilling lent (1999 – 2003)

	1999	2000	2001	2002	2003
Cost per loan made	7434	6023	5499	5146	9303
Cost per unit of money lent	0.2	0.16	0.14	0.09	0.14

Figure 5 Cost of loans made and shilling lent (1999 – 2003)

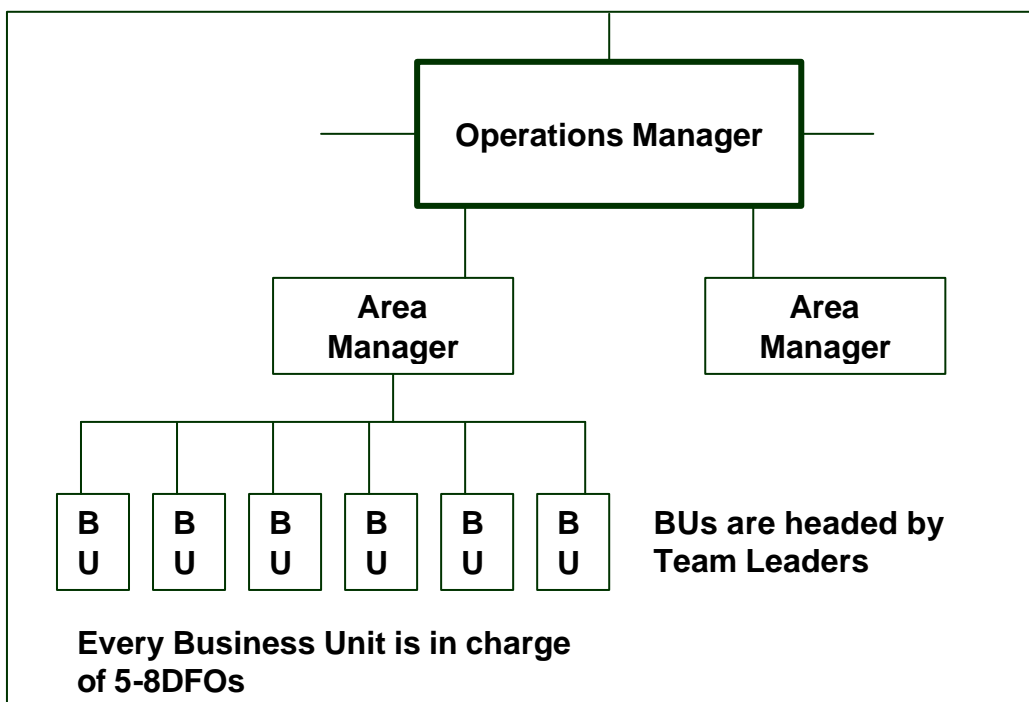


Organization Restructuring (July 2003 – Present)

Re-allocation of Business units was undertaken in June 2003 as part of the restructuring process. Faulu had experienced growth with the same flat organization structure and same number of staff. It had become difficult for operations to supervise DFOs, to motivate staff, to achieve optimal loan collection.

At the beginning of reallocation, Faulu had 5 branches (or hubs) as follows: Nairobi Central, Nairobi East, Mt. Kenya, Nairobi West and 5th Business Unit managed by Branch Managers. A sixth business unit was later created. The Operations Manager supervised the branches managers (now Team Leaders) who also supervised 17-19 DFOs. The 6 branches were re-allocated to 12 business units (hubs) as follows: Central Nairobi, Jogoo Rd, Pumwani, East Nairobi, Thika; Mt Kenya; West Nairobi, Ngong Rd; Nakuru, Meru, Machakos and Molo. Positions of two Area Managers were created to oversee the hubs and report to the Operations Manager. Area Manager 1 is in charge of Central Nairobi, Jogoo Rd, Pumwani, East Nairobi and Thika while Area Manager 2 is in charge of West Nairobi, Ngong Road, Nakuru, Meru, Machakos and Molo (sub-hub). Each hub is headed by a Team Leader who is in charge of 5-7DFOs. The structure is given in Fig. 6.

Fig.6 The decentralized operations structure



One objective of the re-allocation of business units was to create an organizational structure that is more responsive both to clients and staff. In the new structure, the operations manager

supervises two area managers instead of 5 branch managers a factor that now ensures better supervision; a lot of administrative responsibilities such as budgeting and planning that was previously the responsibility of the branch managers have now been removed and given to the Area Managers. The branch managers now work with smaller teams of 5-8 DFOs instead of 17 DFOs. All these measures have enabled the branch managers to focus on supporting field staff and follow-up of bad debts.

One of the results of the re-allocation of business units is that Faulu has been able to reduce its cheque clearing process from 20+ days to 10 working days from the time of loan approval. This is still set to reduce considerably to 5 working days when the current project of Business Process Improvement (BPI) is finalized, as client forms will be posted online from the hubs.

Review basic lending operations and other changes

The restructuring of the business units was accompanied by several institutional measures to ensure that the organization growth is contained and managed. These measures included standardization of credit management procedures and ensuring compliance by the internal audit system. Standardization of operational procedures has been institutionalized in the Loans Policy and Procedures Manual. Faulu frequently observes the changes in its marketing environment and responds adequately. Some of these changes have been institutionalised in documents such as the Operations Charter, Policies Brochure, Products Fact Sheet, Collateral Policy and Interest Rate Changes. The Operations Charter encompasses a new set of risk management tools such as Tolerance Limits for Default, which has an in-built incentive system for DFOs.

The loan delivery mechanism used by Faulu Kenya is based on (a) individuals financed through joint liability groups of 15 – 30 members (b) weekly meetings by clients, (c) adequate training first in six day loan orientation seminars (d) 8-week “savings” first (e) repeat loans with client-progression policies, (f) five loan products offered (g) LSF of 25%, and (g) gender orientation. Faulu has reviewed its basic lending operations to balance its own needs for efficiency and productivity and customer needs for good services. It has reviewed its target market, collateral policy, client incentive system, loan officer incentive systems and interest rate structure.

Redefinition of target Market:

In practice, Faulu’s clients are primarily micro and small-scale entrepreneurs engaged in commercial activities of retail nature with a reasonable number engaged in businesses, agriculture and manufacturing. Clients can access three types of business loans and two types of consumer loans as shown in Table 6 below.

Table 6.4 Product/Market Combinations

	First time Micro and SMEs	Existing Clients graduating from Pamoja Loans	Larger Jua Kali Businesses	Consumer Loans
Pamoja	✓			
Fanaka		✓		
Fanaka Plus			✓	
Elimisha				✓
Mara Moja				✓

Previously, Faulu served Fanaka groups with 5-7 members. The new policy on group size is that all new groups must now have a minimum of 15 members and a maximum of 60 members. Existing groups of less than 15 continue receiving loans but have to add more members by June 2004. This change has been made to emphasise services to the economically active poor¹¹ segment of the market, the original target group of Faulu, which is also 86% of its business. Faulu's focus is now on those requiring loans of Kshs. 100,000 and under. According to the Field Operations Charter, no first loan will exceed KShs100,000 and groups of less than 15 people will not be recruited

Assessment for loan sizes is being enhanced to incorporate both client and business the ability to repay the loan as opposed to using only business ability as the focus. This change has been instituted to enable DFOs make a decision to scale down the loan requested or vary the loan period. As a cautionary measure to DFOs, loans sizes now cannot exceed twice the previous highest loan. Faulu has also proposed that a client cannot have more than two loans at any time – and these loans have to be either Business Loan and Mara Moja or Business Loan and Elimisha. To guard on clients taking more loans than their businesses can manage, consumer loans are given when 50% of the face value of current loans have been repaid.

New incentive system for DFOs

Faulu has instituted a new incentive system for DFOs interlinked with their ability to manage their portfolios. The system is based on the achievement of an effective repayment rate of (90%), loan capacity (80%), maximum number of groups (30) and minimum number of clients per DFO of 360 clients. Improvement on each minimum is rewarded at different levels with the top most reward evaluated on the ideal case of 600 clients, 100% loan capacity, 100% effective repayment rate and not more than 30 groups. Rewards include cash awards and bonuses based on individual pay scales.

¹¹EAP is a person, running a small business, unable to access commercial bank loans and only able to handle a loan of less than Kshs. 1 million

Repayment Incentives for Clients and Interest Rate Reduction

Due to several changes that have taken place in the financial sector regarding interest rates¹² and the pressure to reduce interest rates by clients, Faulu lowered the interest rates for all business loans as follows:

- ☞ Pamoja (22%) – a straight 18%;
- ☞ Fanaka and Fanaka Plus (20%) – a straight 18%;
- ☞ Mara Moja (3%) and Elimisha (4%) – a straight 2%.

At the same time, an incentive system has been created to reward clients with good repayment records. Clients, who pay their first loan (18% interest) with a 100% repayment record, take their second loan at 16%. If they pay this back again at 100% record, they take their third loan at 15%. They can then choose to stay at 15%, while Faulu considers a lower rate in future for those who will maintain the 15% for more than 10 loans. If during the loan period they fall into arrears, they will be allowed to finish repaying this loan at a lower rate, but their subsequent loan goes back to the 18% level and starts all over again.

7.5 Effectiveness of project implementation mechanisms

The effectiveness implementation mechanisms can be gauged by looking at the benefits of the projects and whether the outputs have contributed to the achievement of those benefits, and the unforeseen outcomes and reasons for difference.

Faulu did not anticipate the extent to which very fast growth would constrain the delivery system. Faulu needed to ensure that organization systems are in place to cope with increased administrative burdens that accompany more staff and more clients. These procedures should have been sufficiently tested to ensure that the staff does not make any mistakes and the operating systems should have been ready to support growth. The main challenge became the timing of all the events to ensure that all systems go before the launching of the new products. This turn of events affected the outcome in terms of portfolio quality, client exit, and repayment rates. As a result, Faulu had to undertake a major restructuring of operations to make delivery efficient.

The restructuring led to greater benefits for Faulu. Response to customer needs and wants is faster with the implementation of “Tuongee Forums” and suggestion boxes and the relationship between Faulu Kenya and its clients has considerably improved. Customers are

¹² The interest rates on government paper which is often used as a benchmark for setting interest rates in the market have rapidly reduced to minimal rates in the one year, with the current rate at an all time low of 1.5% for the 91 days T/ Bill. Traditionally, the rates have been high, giving higher yields than most investments. Commercial banks are increasingly coming under pressure from the government to direct funds to the real sector instead of to treasuries and additional disclosure requirements for commercial banks have been introduced requiring disclosure of highest lending rates and lowest savings rates in the local diaries

considerably more “settled” as opposed to early 2003 when customers felt that Faulu did not listen to them¹³. “Tuongee forums are regularly implemented and 1993 alone, over ten (10) such forums were held with clients to explain and re-enforce Faulu’s policies and maintain good will and discuss with clients what clients want or do not want. For example, as a result of the demands from clients to lower interest rates in 2003, Faulu responded by offering its clients an incentive for good repayment and clients pay between 18% and 15% .

Faulu Kenya has clear defined lending policies detailed in the Loan Policy and Procedures Manual which is regularly revised to take into consideration discussions and changes that take place at customer level, especially those issues gathered during the “Tuongee Forums”, from customer complaint boxes and changes in the wider environment such as issues of interest rates and collateral policies. The lending policies are in line with microfinance sound practices in areas of loan processing and approval and default management. The new loans and procedures manual is very comprehensive with sections on portfolio management and reporting and other sections on how to carry out area mapping and analysis, loan assessment, credit risk assessment etc.

The incentive system is clear and well documented and DFOs know the rewards and penalties. FKL’s incentive system is based

As of this year, loan delivery is very fast and has reduced from the former 20+ days to only 10 working days and is set to reduce even to 5 working days with time. As a result of the activity-based costing consultancy and the subsequent costing of products, Faulu Kenya initially managed to reduce wastages, and the cost per shilling lent was at its lowest in 2002 but suddenly increased in 2003 – an area where Faulu needs to refocus.

Faulu’s interest rates are quite competitive and are in line with what the other major MFIs in the Kenyan Financial sector are charging. For example, for loans of less than 100,000 the major MFIs are charging 18-24% while commercial banks are charging between 14%-23% and Faulu charges has reduced from 22% to 18% and even goes down to 15% with good repayment records. The loan terms and conditions are given in Table 4.6.

Faulu partners from USAID have ascertained that the project implementation was very effective and the funds were well spent. During the implementation period, reporting was done according to the contractual agreement or fully discussed between the partner and the Chief Executive Officer of Faulu in crucial meetings or through written communications.

¹³ Customer Satisfaction Survey Report by Fineline Systems and Management Ltd, September 1993

7.6 Efficiency

The efficiency of a project is gauged by whether the results were obtained at reasonable costs, how well the means and activities were converted into results and the quality of results achieved. Even though Faulu Kenya had to incorporate a lot of activities to strengthen the operational procedures, the activities implemented were consistent and adequate for achieving the planned outputs.

7.7 Recommendations

Issues identified	Implications	Recommended actions for Faulu
Worsening of Portfolio Quality	Loan portfolio is the largest asset that Faulu has and therefore when the portfolio quality worsens e.g. in this case a PaR over 30 days of 19.3%, it should be a matter of great concern to Faulu as the risk of not being paid is very high. The benchmark for MFIs is usually <10% since most loans are not backed by bankable collateral.	Understand reasons for worsening Portfolio at Risk and declining effective repayment rates and resolve them. Start with processing information from “Tuongee” forums and Suggestion boxes to understand new client demands and the nature of that demand.
High levels of Client Exit	A great deal of Faulu’s resources is being drained in new recruitments, orientation and loan assessments. The remaining groups would be weaker groups that could easily disintegrate due to the absence of the values that held them together.	Carry out a market research on client perception to find out reasons why Faulu lost 30% of their clients in 2003.
The Challenges of Growth	Staff could be overwhelmed by the number and complexity of activities that took place within the Grant period including the measures undertaken to control the challenges of growth.	Faulu should now consolidate the gains from the institution capacity building programme. A lot of systems are on the ground. There is a need to ensure that the internal systems work before implementing completely new programmes. Any programmes now implemented should strengthen the existing systems in place.

Issues identified	Implications	Recommended actions for USAID
Readiness for Deposit Taking	Faulu Kenya needs to have relevant infra-structures in place for deposit taking in terms of people, products, processes (including MIS), branch networks, and support organizations.	<p>Support Faulu to understand the full requirements of a deposit taking institution e.g. through an institutional assessment to enhance institutional preparedness for deposit taking.</p> <p>Support Faulu to develop its staff and leadership in preparation for deposit taking</p>
Broader Challenges for MFIs e.g. new products, new markets and new services.	Faulu Kenya and other similar MFIs in Kenya face the challenge of moving to the next level in terms of better innovative products that is clearly demand driven. As of today, competition is clearly coming from commercial banks that have gone down market and offering services which were in the domain of MFIs.	<p>USAID should support MFIs in general to understand changes happening in their environment. The starting point would be to work with the Association of Microfinance Institutions in Kenya to collect and disseminate data relevant to its members, including Faulu Kenya</p> <p>USAID could support Faulu to understand the implication of its pilot BDS service before roll-out; as it would have major implications for internal resources.</p>

8 Management Information Systems

8.1 Objectives and planned activities

The objective of the MIS component of the USAID Micro-PED grant-funded project was to ensure that FKL's systems are established to effectively and efficiently achieve the mission and strategic goals of the company.

The initial project budget for MIS related activities was US\$120,143 (including matching funds to be contributed by FKL). These proposed MIS-related projects included:

- Carrying out a systems review to evaluate the adequacy, effectiveness and efficiency of the MIS system and recommend strategies for further growth of the organisation (budgeted for under the Institutional Analysis heading)
- Replacing the DOS-based loan tracking system (LTS) with modern system, and procuring the hardware required to run the new system
- Procure MS Exchange e-mail software and the hardware required to run it.

8.2 Progress achieved against planned activities

The progress received against the proposed activities is as follows:

- The LTS system has been largely implemented, although further work is on-going to enhance the reporting functionality of the package
- The software and hardware to run the MS Exchange e-mail system has been purchased and installed and the system is operational
- The systems review project grew into a Business Process Improvement project and is currently underway

Because FKL overlooked certain USAID procurement rules when contracting the consultancy for the BPI project, the Systems Review budget is no longer USAID Micro-PED funded, and is now being funded by the company directly.

To take up the slack created by removing the BPI project from the list of USAID Micro-PED funded projects, FKL has added the following MIS projects to respond to urgent and important needs of the organisation:

- Implementation of a Microsoft Great Plains (MGP) financial management system
- Implementation of PerPay human resources management system.

The MGP project is at inception stage at the time of reporting, whilst the PerPay project is at implementation stage. Management has indicated that USAID has approved the reallocation of resources to these projects.

Management has also provided assurances that although the end of the USAID Micro-PED project has come and gone, these on-going projects are not in jeopardy because their respective expenditures had been committed and approved before the project cut-off date of end of February 2004.

The key components of FKL's management information systems (MIS) are summarised in table 5.1 below, with planned changes in brackets:

Table 5.1: FKL's MIS software as at March 2004

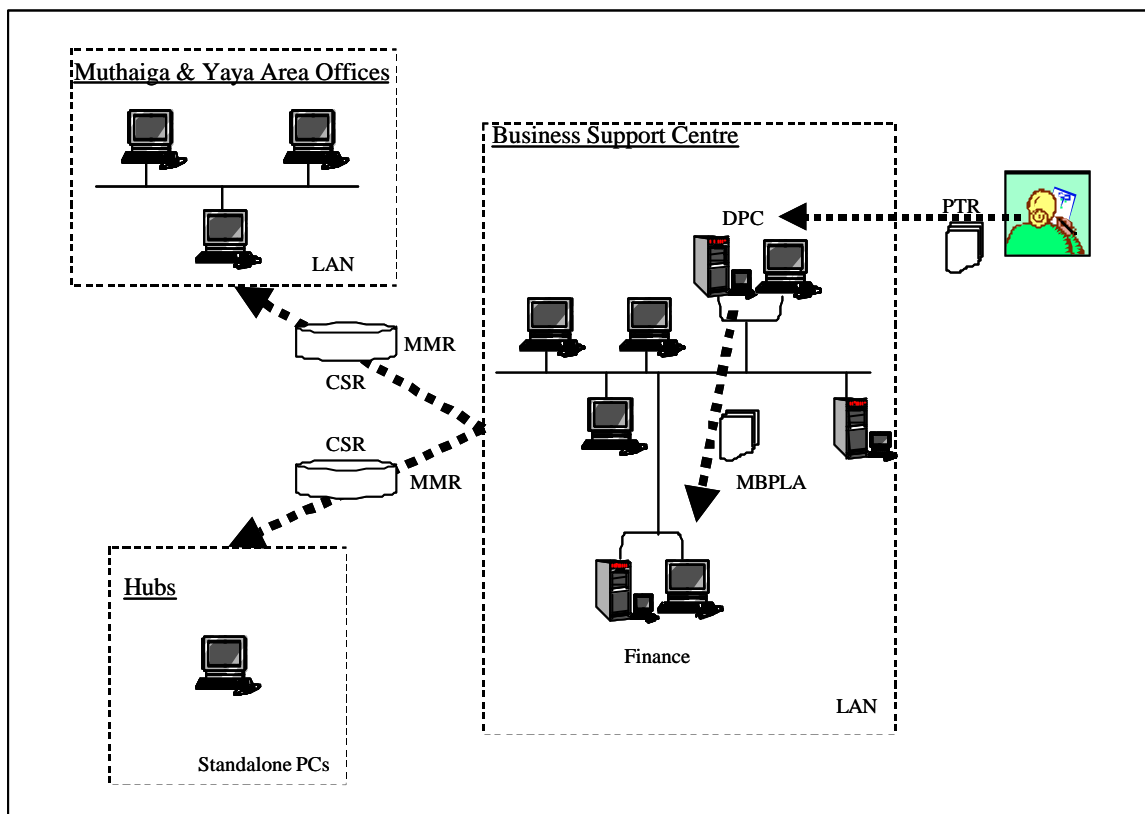
Software	Use
MBWIN	Loan tracking
SunSystems (to be replaced by Great Plains Financial Management System)	Finance and accounting
InfoPay (to be replaced by the PerPay HR Information System)	HR Management
MicroFin	Financial modelling tool

The MIS is based on a Local Area Network (LAN) with client/server architecture at the Business Support Centre. Muthaiga and Yaya Area Offices also have LANs, but based on client-to-client architecture. The hub offices have standalone personal computers (PCs).

At the core of FKL's MIS is the MicroBanking System for Windows (MBWIN), a banking application software system developed under a joint project of the Food and Agricultural Organisation of the United Nations (FAO) and the German Agency for Technical Cooperation (GTZ). It is a complete banking package that integrates the front-office tellering modules (savings, time deposits, current accounts, loan accounts and share account modules) and a back-office General Ledger module. The General Ledger module is, however, not used by FKL because of its limited functionality.

The MBWIN system is installed on two servers, with five databases representing each of the business units (Nairobi Central, Nairobi East, Nairobi West, Mt. Kenya and Business Unit 5).

The regional offices each have a module of MBWIN with no direct link to the Business Support Centre system (see diagram below).



Source: IT Manager

Other than the Muthaiga and Yaya regional offices that have LANs, the rest of the regional installations are on standalone PCs.

The MIS cycle is driven by Period Transaction Reports (PTR) submitted weekly by the DFOs to the head office through their hubs. Data entry is centralised at the BSC Data Processing Centre (DPC) and done in weekly cycles. Once the entered data is validated, a client summary report (CSR) is sent to the hubs offices in magnetic form, where they can be accessed to support decision-making. On a monthly basis monthly management reports (MMR) are produced for key operational and executive staff. Monthly trial balances are also produced for the finance department to facilitate posting of transaction summaries to the SunSystems General Ledger.

Because of the centralised data entry, client information is typically one week old, but given that group meetings are held weekly, this cycle is sufficient for FKL's current needs. This

could, however, be a constraint if the company's business model changes to a deposit-taking one.

FKL's management plans to decentralise data entry and to provide on-line, real-time data through a countrywide wide area network. The system is to be composed of LANs at each site, which are to be interconnected using high-speed digital links to form a secure intranet.

8.3 Efficiency and effectiveness of project implementation mechanisms

Efficiency is gauged by whether the results were obtained at reasonable costs (financial) and how well the means (financial, time, human resources) and activities were converted into results.

Effectiveness, on the other hand, can be gauged by the contribution made by the extent of the achievement of the project purpose.

In the absence of data on the detailed project plans (including Gantt charts, financial breakdown, human resource allocations etc) on which to base our assessment, our review of the efficiency of implementation was restricted to a review of the variance between budgeted costs and actual costs. The table below shows this comparison:

Expense category	Original budget (US\$)			Actual expenditure (US\$)	Over/(Under) Expenditure (US\$)
	USAID Funding	FKL Matching Funding	Total Funding		
Systems review (Included under institutional analysis budget)	11,400	0	11,400	0	(11,400)
Loan tracking system - hardware, software and training	101,971	6,772	108,743	125,182	16,439
Human resources MIS (PeiPay)	0	0	0	20,308	20,308
Financial accounting system (Great Plains)	0	0	0	51,422	51,422
Equipment	0	0	0	12,620	12,620
CISCO Training	0	0	0	700	700
Total	113,371	6,772	120,143	210,232	90,089

The table shows that there was a 75% overrun in the budget for MIS related expenditure. A 75% variance from plan, taken in isolation, would be indicative of both implementation inefficiency and ineffectiveness.

However, the mitigating factors were that implementation of the new financial and human resources systems became immediate priorities given the erratic performance of the systems in place, which threatened to disrupt the business. This is contrary to the original plan, where the project scope would be limited to evaluating options for addressing the MIS issues the organisation was facing, and only procuring the systems in later phases of the company's development programme.

8.4 Recommendations for Faulu

Issues identified	Implications	Recommended actions for FKL
<p>The projects did not provide sufficient information to enable management to effectively control the projects. For example:</p> <ul style="list-style-type: none"> • Management set budgets and time frames for the LTS project without detailed specifications and planning – the result is that the budget (though overspent), constrained the project. Consequently further development work that still needs to be done could be hampered by budgetary constraints. • Discussions with several senior managers failed to surface the non-ambiguous, quantifiable objectives of the BPI project 	<p>Cost overruns, unsuccessful projects, over or under-investment in important projects, unmet business needs, over-engineered projects.</p>	<p>Detailed and structured planning of projects to ensure:</p> <ul style="list-style-type: none"> • Institutional needs are properly diagnosed • Costs are properly controlled • Project delivery timetables are properly controlled.
<p>FKL's disaster recovery plan (DRP), though existent, is not documented</p>	<p>The fact that the plan is not documented implies that FKL is over-reliant on the continued employment of the IT Manager and his personal recollection to manage disaster risks.</p>	<p>FKL is at the stage in its growth when it should be focusing on building institutions to reduce its reliance on individuals and safeguard institutional continuity. The DRP should be documented as soon as possible to facilitate delegation and continuity should there be a change in the IT Manager position.</p>

8.5 Recommendations for USAID

Issues identified	Implications	Recommended actions for USAID
<p>The large variations in the scope of the MIS related projects are as a result of insufficient work done at proposal stage in identifying and prioritising the institutional needs of FKL.</p>	<p>Poor control over project and significant variations of project scope during implementation.</p>	<p>Future projects of a similar nature to be funded by USAID Micro-PED should be preferably be within the context of:</p> <ul style="list-style-type: none"> • Completed, thorough and prioritised institutional needs assessment • An IT strategy to ensure that the recipient of the funding has clearly thought the project through and understands their priorities and their strategic contexts • Detailed and thorough project plans to facilitate ex-poste review of time, cost and human resource utilisation efficiency in project implementation

9 Networking

Faulu Kenya has played a significant role in the founding of the Association of Micro finance Institutions (AMFI) in Kenya. AMFI is made up of institutions that deliver micro-finance services and runs a full time secretariat that continually addresses common problems and issues within the MFI industry in Kenya. AMFI is currently working with the Government and various other stakeholders to see to the enactment of a Micro-finance Act that will enable such institutions to be recognized and licensed under a specific law that will enhance their ability to offer more broad based services. Private capital can also be attracted into the sector through a law of this nature. Faulu Kenya's Chief Executive is the current Vice Chairman of AMFI and also a Director of the African Micro-finance Network (AFMIN), based in Abidjan, Cote de Ivoire.

ANNEX 1: TERMS OF REFERENCE FOR PROJECT EVALUATION

A. BACKGROUND TO FAULU KENYA

Faulu Kenya is a Microfinance institution with close to twelve years experience of offering financial services to MSEs in urban and rural Kenya.

Registered in Kenya as a limited liability under the Companies Act, and whose sole shareholder is Food for the Hungry International (FHI), Faulu currently is serving over 20,000 clients, and has a total portfolio of over Ksh 500 million. Faulu has ten Business Hubs (Units) spread across 27 districts in Kenya, and a staff of 118 members.

A 7 member Board of Directors governs Faulu Kenya. A detailed profile of Faulu Kenya is attached to this terms of reference.

B. BACKGROUND TO THE USAID FUNDED PROJECT

Three years ago, Faulu Kenya sought a grant from USAID, to strengthen its capacity towards becoming a fully commercialized microfinance company having shifted from an NGO platform. The four key result areas for institutional capacity building were as follows:

- Faulu Kenya Ltd (FKL), mission and strategic goals clearly articulated and lived out by the board, Management and staff
- FKL systems, established to effectively and effectively achieve the mission and strategic goals of the company
- FKL with a capacity to attract resources needed to achieve the mission and strategic goals of the company
- FKL with productive linkages with a variety of networks, organizations and agencies in the country and the region

On February 28, 2001, the U. S. Agency for International Development (USAID), Mission to Kenya (mission) approved support to Faulu/Kenya, under the USAID MICRO-PED project to carry out this program on capacity building. This would also enable Faulu Kenya to provide more micro-finance services to micro and small enterprises The support was for an amount of \$430,450.

Initially the grant was sought for two years but a no-cost extension was granted for a third year, ending February 2004.

Some of the specific purpose to which this support was to be applied is as follows:

- Strengthen the role of the Board of Directors through workshops and exposure visits

- Human resource development: Training and exposure visits for management and credit officers.
- Research and product development: Develop new products and services, active research on indigenous systems for micro-lending and savings; develop growth and market penetration strategies for existing and new markets; strengthen lending procedures and operations.
- Systems development: Up-grade the loan tracking system and improve management information system; establish internal control systems.

The funds were to be utilized under the following program budget line items:

Governance Development	32,502
Management & Staff Development	92,156
Research and Development	47,399
Institutional Analysis	56,700
Audit, Evaluation and Monitoring	42,139
Training and Equipment	12,300
Loan Tracking Systems/Hard/Soft	125,254
Program Vehicle	22,000
Total	430,450

Faulu\Kenya was required to contribute \$112,090 as a cost share match.

C. PURPOSE OF THIS EVALUATION

The purpose of this is to:

1. Assess the progress of the project in achieving its objectives
2. Assess the efficiency, effectiveness of the project implementation mechanisms
3. Determine the impact of the project on Faulu Kenya
4. Provide specific recommendations for Faulu Kenya and USAID that will guide the design and implementation of similar projects in the future

D. SCOPE OF THE EVALUATION

The evaluation will be carried out against the expected project impact/result areas that had been set out at the beginning of the project.

I. PRE-REVIEW STEPS

- The evaluator is expected to review the applicable documentation and program reports considered necessary to perform the review and,

- All applicable procurement policies and procedures; receipts, warehousing and distribution procedures for materials, supplies and equipment necessary to successfully complete the required work will be availed.

Further, towards the achievement of the results look at the following areas:

II. EFFICIENCY

Efficiency in the use of project funds, analyzing the relationship between the inputs and activities versus the outputs/ outcomes. Assess in particular whether

- The original workplans have been complied with? Achievements? Major deviations? Causes for the deviations? Effects of such deviations?
- Were the resources efficiently transformed into outputs?
- Were the activities consistent with and adequate for achieving the planned outputs/outcomes
- Assess the quality and procedures and processes and methodologies utilized by those involved
- Assess the institutional arrangements adequacy towards the support and efficiency of management and usage of resources to achieve the results

III. EFFECTIVENESS

Effectiveness towards the utilization of resources to achieve the results/outcomes
Towards the result areas/ set outcomes assess whether these were effectively achieved.
Specifically

- Look at benefits of the project to date
- Have the outputs contributed to the achievement of these benefits?
- Opinions of project partners towards the effectiveness of the project and suggested improvements for future
- Unforeseen outcomes and reasons for differences

IV. IMPACT

Briefly assess the impact of the project to date on Faulu Kenya Limited, with particular attention to all the result areas and budget items. Access changes in business management, levels of income, business volumes, employment creation, investment, confidence etc

V. SUSTAINABILITY

Towards this assess the project's positive outcomes/results continuity. Specifically the evaluation to look at;

- Interest of sustaining the results that has been created in the institution
- Ability and commitment to continue with project implementation and maintenance
- Ability for the outcomes to be self sustaining or to increase institutional self sustainability
- Assess the risks that could limit the sustainability of the project and how these can be minimized or mitigated

VI. *CROSS CUTTING THEMES*

Evaluate the project results/ outcomes against the cross-cutting themes touching on

- Gender

To what extent the needs, constraints and possibilities of women taken into account at implementation stages

- Environment

Assess the extent to which issues relating to the environment were taken into consideration in the implementation of the project and the overall impact if any on the same

E. DELIVERABLES

A key outcome of the consultancy is a report of the evaluation exercise. Three copies of a draft report will be provided to Faulu Kenya – that addresses the issues above and specific recommendations of the evaluation. A final report will be prepared incorporating comments by Faulu and USAID. The consultant shall submit a final report on a 3 ½ diskette in MS Word and three hard copies. Acceptance of the report by Faulu will be contingent upon the report adequately fulfilling the scope of work and addressing major important areas of inquiry outlined in the scope.

The report will follow the format below:

- a) Executive summary
- b) Table of contents
- c) Main body of the Report
- d) Annexes (if appropriate)

F. PLAN OF WORK

Prepare a work plan towards accomplishing this assignment.

G. TEAM COMPOSITION AND REQUIRED EXPERTISE QUALIFICATIONS

The evaluation team shall include one specialized professional in the microfinance sector with special skills on micro lending, microfinance management, information systems, and institutional development activities

Required Qualifications

- Extensive experience in microfinance operations and exposure to a variety of Microfinance institutions and models in Kenya and other parts of the world
- Masters in finance, management, economics, financial analysis, development studies and/or the social sciences
- Experience in working with NGOs or non-banking microfinance institutions
- Knowledge of microfinance best practice methods
- Excellent consulting and communication skills with demonstrated ability to work collaboratively at a senior level
- Previous experience in evaluation and impact assessing

H. LOGISTICAL SUPPORT

The consultant shall be responsible for all logistical support required for this assignment including secretarial services, photocopying, telephone services, travel and accommodation, etc

I. REPORTING REQUIREMENTS

The work is expected to start on/or about February 27, 2004 and the final report submitted to Faulu on or before March 26, 2004. A briefing by Faulu and USAID will take place at the start of the consultancy and there will be a debriefing for stakeholders at the end of the evaluation.

J. SELECTION CRITERIA

The consultant for the evaluation will be selected according to the following criteria:

- Masters in finance, management, economics, financial analysis, development studies and/or the social sciences – 15 Points
- Extensive experience in microfinance operations and exposure to a variety of microfinance institutions and models in Kenya and other parts of the world – 20 Points
- Previous experience in evaluation and impact assessment – 30 Points
- Experience working with developmental NGOs or non-bank MFIs – 20 Points
- Experience in consulting and communication skills with demonstrated ability to work collaboratively at a senior level – 15 Points